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THE IMPACT OF THE DEBT CRISIS ON THE U.S. ECONOMY

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BEFORE THE

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CONGRESS OF THE UNITED STATES

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THE IMPACT OF THE DEBT CRISIS ON THE U.S. ECONOMY

MONDAY, JUNE 17, 1985

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to notice, at 10:05 a.m., in room 2359, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representative Obey and Senator Proxmire.

Also present: Don Terry, Democratic staff director; and Kent Hughes and Sandra Masur, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative Obey. Good morning.

Today, the Joint Economic Committee begins a series of three hearings on the international debt crisis and its impact on the U.S. economy. Although the Latin debt crisis, for instance, and its impact on us has largely been off the front pages for the last couple of years, it has by no means been solved. Latin governments continue to struggle to make interest payments on foreign debt. Latin economies are deteriorating, unemployment is rising, and political opposition to continued austerity is always present.

Thus, the Latin payment crisis is still very much with us and it affects in vital ways the performance of the U.S. economy.

Furthermore, if the slowdown in the U.S. economy persists, we could very easily see another round of crisis management. We all hope that that will not happen, but it's certainly possible—and international financial instability of equal, if not greater, magnitude than we witnessed in the summer of 1982.

No doubt there is growing sensitivity in the Congress to the impact of the global economy on our own economic well-being. Rising imports, poor U.S. export performance, and the uncompetitive dollar are all topics of concern and focus.

Oddly enough, however, the domestic economic problems associated with the Latin debt crisis have been largely ignored. Japan has become the symbol of all of our trade problems and frustrations. And to be sure, inadequate access for United States goods in Japanese markets is a legitimate problem which warrants attention and correction.

But our trade problems with Latin America, in many respects, parallel the problems we face with Japan. They certainly do so in overall magnitude. We enjoyed a surplus in our trade with Latin

America throughout the seventies. In 1980, our surplus was $4.8 billion. That has deteriorated to a $15.7 billion deficit last year and is likely to get worse. That $20 billion turnaround rivals the deterioration in our bilateral trade relations with Japan.

Today's witnesses have been asked to review the causes of the Latin debt crisis, where we stand today, and have been asked to document the impact of this crisis on the U.S. economy in terms of lost jobs and growth.

The second hearing will focus on the debt problems' effect on specific industries, such as construction and engineering, heavy equipment or farm machinery.

The third hearing will include testimony on the ability of Latin countries to continue to meet their debt obligations, the additional problems that could arise if growth in the U.S. economy remains weak, and the stability and continued viability of democracy in Latin America.

Today's witnesses are Mr. Jerry Adams, Wharton Econometric Forecasting and the University of Pennsylvania, and Mr. John Petty, chairman, Marine Midland Banks, and former Assistant Secretary of the Treasury for International Affairs in the Ford administration.

Mr. Adams, why don't we begin with you? And because I have not had an opportunity to read either of your prepared statements, instead of summarizing, why don't you just go through the full statement, unless you have a time problem? That will give me a better opportunity to understand exactly what it is you're saying before we proceed with questions.

STATEMENT OF F. GERARD ADAMS, UNIVERSITY OF PENNSYLVANIA, AND WHARTON ECONOMETRIC FORECASTING ASSOCIATES, INC.

Mr. **Adams**. Thank you, Mr. Chairman, for inviting me to express my views before the committee.

I'll do as you suggest, go through the entire prepared statement. I may occasionally add some comments and perhaps eliminate a paragraph here and there. I'll warn you so that you can follow it.

Representative **Obey**. I'll do the same thing.

Mr. **Adams**. As you already pointed out and as we are all too well aware, the international debt crisis has been like the multiple episodes of a cliffhanger. Since 1982, when the crisis first dropped into the consciousness of bankers, government officials and economists, and finally, the public at large, the situation has never been far from the headlines. And, indeed, we see that in yesterday and today's headlines as well. The good news has been that so far, the crises have been managed and the crash averted. The risk of default and of shock to the international banking system is still considerable, but the institutions have proved remarkably robust and the efforts by the IMF, the commercial banks, and the debtor governments have so far proved effective in avoiding the worst potential outcomes.

In the process of watching the daily events, many observers have lost sight of the bad news. The bad news is the continued severe impact of the debt overhang on the economies of the debtor countries and on the economies of the creditors as well. The Latin American debt crisis has adversely affected the economy of the United States and continues to do so. So I am concerned in this testimony with the impact of the debt situation in Latin America and on the United States. I'm going to begin by commenting on the development of the debt crisis and then I want to turn to its impact and make some concluding comments on future prospects and solutions.

The general recognition of the debt crisis as an American problem came suddenly in August-September 1982, around the time of the World Bank-International Monetary Fund meeting in Toronto, when Mexico and Brazil indicated that they were unable to find continuing financing for their debts and sought aid from the United States.

Between 1977 and 1982, the external debt of the six largest Latin American countries—Argentina, Brazil, Chile, Columbia, Mexico, and Venezuela—increased from $95 billion to $272 billion, an increase of $177 billion in 5 years and an increase of $56 billion in just 1 year, from 1980 to 1981, alone.

As we know, of the total Latin American debt outstanding, a predominant share was lent by U.S. banks and an increasingly large part consisted of short-term credits linked closely to prevailing interest rates.

The debt built up in the 1970's surprisingly quickly. If one looks across the various countries, one finds that the debt buildup is not simply explainable by one factor. Clearly, in some cases, the debt was incurred because countries were unwilling to bear the real burden of high energy costs and finance these imports by rising debt. Brazil is a case in point.

In some countries, however, the debt was incurred in order to finance excessively rapid development plans. And that's clearly the case in Mexico, which had oil, after all, and foresaw the growth of these oil revenues more rapidly than was eventually to materialize. And like in the Brazilian case, some of those funds went for development purposes.

Finally, some of the money went for speculative activities. That's the case in Argentina. So that in some cases, the funds were used productively; in others, they were not.

The other point that perhaps ought to be made about that buildup is that it takes two to tango and that this was a period when American banks were pleased to make loans at high interest rates and like sovereign debts, which they considered to be secure.

So there are two participants in this game—on the one hand, the borrowing of the borrower countries; on the other hand, the willing lending by the lenders.

I have said in this paragraph that wide recognition of the crisis dates to August-September 1982. The fact is, however, that certain bankers were aware of the possibility long before that. I remember a U.N. meeting in Geneva with an economist from the American Express Bank in London who at that time was warning quite clearly that the debts were rapidly exceeding the capitalization of the lending banks and that sooner or later, the banks would have to put a stop to this lending. That was 2 years before 1982.

The interest burden rose from 12.7 percent of exports in 1977 to 32½ percent of exports in 1982, partially, of course, as a result of the larger debt, but also partially as a consequence of the unexpected rise of interest rates. And the debt service ratio, including repayment of maturing loans, rose from 32.8 percent of exports in 1977 to 60.3 percent in 1982.

As you know, as I've mentioned already, the critical turn in the debt situation came in mid-1982. Until then, the commercial banks had been willing to underwrite continued rapid expansion of debts, even though their holdings of country debt obligations greatly exceeded the capitalization.

As the inability of the countries to meet their debt obligations without assistance became apparent, the commercial banks would have liked to withdraw from further Latin America lending. When the banks were unable to reduce their exposure and further cut loan extension, what William Cline has called involuntary lending was required in order to avoid defaults. Such lending, by the way, amounted to about $14 billion in 1984.

The situation since 1982 has been characterized by repeated crises. Each renegotiation, after all, could be seen as a sort of a crisis process. The initial one in the fall of 1982, and again the situation in mid-1984, are illustrative. The IMF has negotiated agreements with the debtors, conditioned on economic targets and policy reform and, in turn, the banks have provided limited additional lending to avoid a financial crash.

This process was particularly notable in mid-1984, when a variety of events seemed to suggest that the crisis would be inescapable. The debtor governments were meeting in mid-1984 in Cartagena at what appeared to be the formation of the debtors' cartel. Banks in the United States were shaken by the difficulties of Continental Illinois and it appeared that the commercial banks would not be able to extend more credit. Finally, the targets set by the IMF, particularly for inflation, were not being achieved, although the external trade balance objectives were exceeded in some cases. The flexibility shown by the various participants in the bargaining process is a welcome omen that future crises can also be managed.

We've seen a number of recent examples of this in the past week—the developments in Argentina, the rescheduling in Mexico are all cases where a great deal of flexibility was shown by the participants and that was a helpful factor.

The debt crisis has provoked serious economic adjustment in Latin America. These adjustments have gone a long way toward easing financial pressure and greatly affect living standards, and they've had significant impact on the United States as well.

The striking fact is the drastic change in trade balances. I'm dealing here in almost all cases with data for the six major Latin American countries. From an approximately balanced merchandise trade in 1981, we've gone to a surplus of $36.4 billion to cover the interest bill on the outstanding debt, so that in 1984, their current account was actually roughly in balance.

This change was accomplished first through a cutback in imports. In the principal countries, imports were diminished from $78 billion in 1981 to $46 billion, approximately, in 1984. An expansion of exports came on later. The recession which resulted in the principal Latin American countries has reduced per capita income by some 9 percent on average from 1980 to 1983. But significant disequilibrium still exists—runaway inflation in Brazil and Argentina, and large public sector deficits, and so on.

While the pressures appear to have been temporarily defused, threats of default by smaller debtor countries, arrearages of interest payments, and difficulties in reaching restructuring agreements with the bigger countries represents risks of renewed crisis.

The effect on the United States has not gone unnoticed. Indeed, it's very interesting to look at the trade statistics in the summer of 1982, when the sudden deterioration of United States exports to Mexico was one of the first signals of the impending crisis. The United States stands on the flip side of the improvement of the Latin American trade balance, since the bulk of Latin American trade is in a north-south direction, and particularly with the United States.

As shown in table 3, the United States exports to Latin America deteriorated from $39 billion to $26 billion—$39 billion in 1981 to $26 billion in 1984. In return, U.S. imports have increased sharply, from $32 billion in 1981 to $42 billion in 1984.

These numbers are based on U.S. trade statistics with Latin America.

The trade balance has swung from a surplus of $7 billion to a deficit of $16 billion, a change which is concentrated, for the most part, in manufactures.

Now, it can be argued that not all of this swing is attributable to the debt crisis. U.S. trade has deteriorated with respect to other parts of the world as well.

On the other hand, the Latin American picture is dominated by the debt situation and it was the debt burden which made such a trade turnabout imperative. The magnitude of the trade swing is probably just about what was necessary to make the debt manageable.

What is the impact of trade readjustment on the U.S. economy? In order to gauge the impact, my colleague at Wharton Econometrics, Kurt Carl and I have introduced a trade swing of $23 billion into the Wharton annual model of the U.S. economy. The impact of the change in trade flows is approximately $65 billion on current GNP. I summarize these various dimensions of this in table 5.

In real terms, the impact is about $18½ billion in 1972 dollars, approximately 1 percent of GNP. This accounts for approximately 800,000 jobs. The number 800,000 comes out on the high side as far as my expectations are concerned. The explanation of why it is on the high side is that the bulk of this swing in trade is concentrated in manufactured goods, not all of it, but more than two-thirds. We've put it into the model this way and we get an impact of about 800,000 jobs.

Other aspects of this change are shown in table 5, and particularly notable, of course, is the impact on particular industries. Here, the biggest impact is in the primary metals, motor vehicle, and in the miscellaneous manufacturing industries.

We might have stretched our baseline assumption somewhat further, assuming, for example, that Latin American growth had continued into the 1980's at the pace of the previous decade. And had we done so, we would have seen a larger trade swing and still a bigger impact. But I think that such an assumption lacks realism in that to assume that growth would continue would have required us to assume that lending would continue, when that clearly is not feasible.

We tried to say something about the impact of Latin American crisis on the dollar exchange rate, but I must say, that's a very difficult thing to evaluate. Obviously, if we were looking at the bilateral exchange rates between the United States and various Latin American countries, the demand for dollars relative to the supply has sharply pushed up the value of the dollar. The exchange rates of the Latin American countries vis-a-vis the dollar have moved, moved enough to effect a very sizable trade swing and some more, presumably, because of the financial pressures.

This bilateral exchange rate relationship has already been allowed for in our calculation. We've taken effectively the imports and exports that have resulted and introduced the swing of those into our calculation.

An altogether separate issue is whether the situation has caused the dollar to be high relative to other currencies as well, and whether that would reduce the U.S. competitive position with respect to third country markets and thereby affect U.S. trade and economic activity.

I think, on balance, it's not possible to provide an unequivocal answer. It's quite clear that capital flows have been toward the United States and that has tended to raise the dollar. It's been effectively a flight of capital, not only from Latin America, but from many countries toward the United States. On the other hand, the precariousness of the Latin American debt has raised fears about the state of the U.S. banks and that may, in fact, discourage some capital movement to the United States. So it's not clear to us whether the value of the dollar with respect to the currencies of Europe and Japan has been affected, nor is there clear evidence of the impact on interest rates.

As we note earlier, the successive debt crises have been defused. There are still significant arrearages with respect to several of the smaller countries, and even with some of the large ones, but outright defaults have been avoided. This has minimized the potential impact on the banking system, although certainly we can't assume that there is no impact.

We have noted the large value of holdings of Latin American debt by U.S. banks relative to their capitalization. Bill Cline's numbers point to figures from 100 to over 200 percent, in the case of some of the banks.

On the one hand, such figures exaggerate the risk, since there's no question of writing off 100 percent of Latin American debt. On the other hand, such figures do not account for the expectational impact, fears of depositors and the possibility of a premium in interest rates as a result of increased risk.

However, it's our judgment that such risk premiums have been small so far.

The probability of an outright default in the future is real, of course, but it is small. Nevertheless, such an event could have significant implications for the developed economies. We've studied that sort of possibility at some length, although it's very difficult to study the possibility of a default because there are so many things that can go wrong. It's very unclear exactly how a default would operate and, moreover, it's very unclear what the policy responses would be. The impact of a default depends, to a very large extent, on what the policy response on the part of the Federal Reserve would be.

Our calculations would suggest that a default could lead to a recession in the United States and certainly would mean a long-term reduction in the growth prospects of the Latin American countries.

Next, I consider the prospects for the Latin American debt situation. Last year was one of almost universal recovery in Latin America, with regional GDP growth at 3.3 percent and the first increase in per capita GDP since the beginning of the debt crisis. The major countries showed surprisingly good balance of trade results and, as a consequence, the current account of the six major countries achieved a small surplus.

But it is important to note that domestic economic performance was still deficient in most Latin American countries, which high unemployment rates, per capita income some 9 percent below earlier peaks, and runaway inflation particularly in Brazil and Argentina. The domestic performance of most of these countries remains far outside the bounds of the conditions proposed by the IMF. Nevertheless, the favorable element is that, despite the serious economic difficulties, progress toward political opening in the direction of popular democracies is still being made in many countries, particularly in Brazil.

There are prospects for some further improvement in the economic situation throughout Latin America, except in Argentina for next year. For the region as a whole, growth can be expected at 2.8 percent in 1985 and then we project 4 to 5 percent annual growth of GDP for the later years of the decade.

Unfortunately, that 4 to 5 percent projection, which would look healthy from the perspective of a developed country, nevertheless falls considerably below the growth rate of the most favorable recent decades in Latin America and it doesn't recoup the welfare losses suffered as a result of the debt problem.

Whether one can say that the debt situation has been overcome is largely a matter of perspective. Default has been avoided and with increased flexibility on the part of the lenders, it is likely that restructuring agreements will ultimately be reached with many countries.

But from another perspective, the burden on the debtor countries continues to be a heavy one. The terms of trade have gone against the debtors. In order to service their debt, the Latin American countries transfer some $30 billion annually to their creditors. While limited lending has continued in order to avoid defaults, traditional flows of capital from the developed to developing countries have all but dried up.

From the perspective of trade and balance of payments, the slowing of exports from the major Latin American countries in the first quarter of 1985 suggests that the spectacular trade performance of 1984 will not be repeated. And the softness of oil prices promises difficulties for Mexico and Venezuela.

On the other hand, the easing of interest rates is worth about $3 billion for each percentage point of interest rate reduction and that's a favorable prospect.

Let me add at this point that there is, quite properly, considerable concern about the impact of a potential slowdown in the U.S. economy on the expansion of Latin American trade. We are not predicting a recession, but we are every week marking down our forecast for the U.S. economy. The U.S. economy has been slow and sluggish. And, indeed, I suspect that the slowing of Latin American exports, which has been widely observed in the first quarter of 1985, is already a reflection of a slowdown in demand in the United States.

So that the situation from the trade side certainly does not look favorable in 1985. not nearly as favorable as in 1984, and it may worsen as a consequence of slowing economic conditions in the United States.

On the other hand, the quite sharp decline in interest rates which has occurred in the last couple of months is certainly a positive factor from the perspective of Latin America, and one can ask to what extent is there a tradeoff between these two.

I have some brief comments about what can be done about the problem. It's clearly not a situation which will disappear quickly, even if default can be avoided, and that's our most probable outcome. There will be repeated negotiations, in themselves costly and disruptive. The resource costs to the developing economies of Latin America will continue.

The debt overhang will affect Latin American growth for many years to come. So will the impact on the U.S. trade balance and on U.S. industries. And that means that there is considerable commonality of interest between the debtor countries and the United States in resolving the problem.

In very general terms, what are the possibilities? First of all, it goes almost without saying that proper management of economic policy to establish a healthy and growing world economy with realistic interest rates is a basic requirement. The runup of real interest rates was certainly a contributor to bringing on the debt crisis. I don't think that the debt expansion was sustainable, even without the runup of interest rates that occurred in 1981 and 1982, but it was certainly that runup of interest rates which brought on the crisis in the immediate sense. Much could be achieved with a more balanced economic policy, one that has easier monetary policy with lower interest rates and reasonable, but not excessive, fiscal stimulus to set the world economy on a limited growth path. Lower interest rates would ease the burden on the debtors. The growth of demand would provide markets for the products of the Latin American economy.

I will summarize other approaches very briefly here. One of them is to meet the problems of default: increasing the flexibility of the IMF, of other international institutions and of the commercial banks in dealing with crisis situations.

Second, a stretching out of the debt and the reduction of the instability of interest rates. The critical issue here is the conversion of short-term debt at variable interest rates into longer term funding at stable, predictable, preferably lower rates of interest.

And, finally, I think it's time to evaluate the long-term implications to try and distribute the burdens more equitably on a no-fault basis. The issue here is not to hold one party or the other responsible, but to recognize that the debt has become burdensome to both creditors and debtors. There have been a number of proposals that have been made which would try to reduce the rate of interest, perhaps offer some public guarantees, and convert the outstanding credits into new forms of securities. There are all kinds of possibilities along these lines and they deserve serious consideration. Thank you.

[The prepared statement of Mr. Adams follows:]

PREPARED STATEMENT OF F. GERARD ADAMS

Perspectives on The Latin American Debt Crisis

Implications for Latin American Development and for the United States Economy

As we are all too well aware, the international debt crisis has been like the multiple episodes of a "cliff hanger". Since 1982, when the crisis first dropped into the consciousness of bankers, government officials, economists, and finally the public at large, the situation has never been far from the headlines. The good news has been that so far the crises have been managed and a crash averted. The risks of default and of shock to the international banking system are still considerable, but the institutions have proved remarkably robust and the efforts by the IMF, the commercial banks and the debtor governments have so far proved effective in avoiding the worst potential outcomes.

In the process of watching the daily events, many observers have lost sight of the bad news, the continued severe impact of the debt overhang on the economies of the debtor countries, and on the economies of the creditors as well. The Latin American debt crisis has adversely affected the economy of the United States and continues to do so. This testimony is concerned with the impact of the debt situation on Latin America and on the United States. We begin by commenting on the development of the debt crisis. Then we turn to the impact. We conclude with an evaluation of future prospects and potential solutions.

Development of the Debt Crisis

Recognition of the international debt as an American problem came suddenly in August-September 1982, around the time of the World Bank-International Monetary Fund meeting in Toronto, when Mexico and Brazil indicated that they were unable to find continuing financing for their debts and sought aid from the IMF. (Debt problems earlier in the 1970s concerned African countries and Eastern Europe and could be seen either as isolated country problems, in the African case, or as primarily a European concern in the case of the Socialist countries.) Between 1977 and 1982, the external debt of the six largest Latin American countries (Argentina, Brazil, Chile, Colombia, Mexico, and Venezuela) increased from $95 billion to $272 billion--an increase of $177 billion in 5 years and an increase of $56 billion from 1980 to 1981 alone (Table 1). Of the total Latin American debt outstanding, the predominant share was lent by United States banks. Moreover, an increasingly large part consisted of short term credits linked closely to prevailing short term interest rates. The interest burden rose from 12.7 percent of exports in 1977 to 32.5 percent of exports in 1982--partially as a result of the larger debt but also as a consequence of high interest rates--and the debt service ratio (including repayment of maturing loans) rose from 32.8 percent of exports in 1977 to 60.3 percent in 1982.

The critical turn in the debt situation came in mid 1982. Until then the commercial banks had been willing to underwrite continued rapid expansion of debts, even though their holdings of country debt obligations greatly exceeded their capitalization (Cline, 1984). As the inability of the countries to meet debt obligations without assistance became apparent, the commercial banks would have liked to withdraw from further Latin American lending. But the banks were unable to reduce their exposure and further credit extension, what William Cline has called "involuntary lending", was required to avoid defaults. Such lending has amounted to $14 billion in 1984.

The situation since 1982 has been characterized by numerous crises. Of these, the initial one in the fall of 1982 and again the situation in mid 1984 illustrate how the situation has been defused. The IMF negotiated with the debtors agreements conditioned on economic targets and policy reform and in turn the banks provided limited additional lending to avoid a financial crash. This was particularly notable in mid 1984 when a variety of events together seemed to suggest that the crisis would be inescapable. The debtor governments were meeting in Cartagena at what appeared to be the formation of a debtors' cartel. Banks in the US were shaken by the difficulties of Continental Illinois (difficulties which were related to domestic rather than to foreign lending) and it appeared that the commercial banks would not be able to extend more credit. Finally, the targets set by the IMF, particularly for inflation, were not being achieved (though the external trade balance objectives were exceeded in some cases). The flexibility shown by the various participants in the bargaining process, which ultimately helped to avoid a crisis in 1984, is a welcome omen that future crises can also be managed.

Adjustment of the Debt Crisis

The debt crisis has provoked serious economic adjustment in Latin America. While these adjustments have gone a long way toward easing the financial pressure, they have greatly affected living standards and they have significant impact on the United States as well.

The striking fact, observable in Table 2, is the drastic change in trade balances which has taken place in the six major Latin American countries in the last 4 years. From an approximately balanced merchandise trade (six largest countries) in 1981, they have gone to a surplus of $36.4 billion to cover the interest bill on the oustanding debt so that their current account was in balance in 1984. The change was accomplished first through a cutback in imports. In the principal countries (Table 2), imports were diminished from $78.3 billion in 1981 to $45.8 billion in 1984. An expansion of exports only came later, in 1984 particularly, going from exports of $78.3 billion in 1981 to $82.3 billion in 1984. The recession which resulted in the principal Latin American countries has reduced per capita GNP by some 9 percent from 1980 to 1983. Moreover, significant disequilibrium still exists--runaway inflation rates in Brazil and Argentina, and large public sector deficits. A long term debt restructuring has been achieved in Mexico but more adjustments will be necessary before additional debt restructuring agreements can be reached. While the pressures appear to have been temporarily defused, threats of default by the smaller debtor countries, arrearages of interest payments, and difficulties in reaching restructuring agreements with the bigger countries represents risks of renewed crisis.

Effects on the United States Economy

What are the channels through which the US economy has been affected? First is the direct channel of exports to Latin America, an important market for US products, and imports from Latin America. Secondly is the impact on financial flows, the flow of US lending to Latin America, a supply of dollars, and the flow of debt service payments, a demand for dollars. Finally, there is the threat to the stability of the United States banking system from outright default or writedowns of Latin American debt.

The impact on the United States trade has not gone unnoticed. Indeed, in the summer of 1982, the sudden deterioration of US exports to Mexico, was one of the first signals of the impending crisis. The United States stands at the "flip side" of the improvement of the Latin American trade balance. Since the bulk of Latin American trade is in a North-South direction and particularly with the US. As shown in Table 3, United States exports to Latin America deteriorated from $39.0 billion in 1981 to $26.3 billion in 1984. In turn, US imports have increased sharply from $32.0 billion in 1981 to $42.3 billion in 1984. The trade balance has swung from a surplus of $7.0 billion to a deficit of $16.0 billion, a change which is concentrated for the most part in manufactures (Table 4).

It can be argued of course, that not all the swing in US-Latin American trade is attributable to the debt crisis. US trade has deteriorated with respect to other parts of the world as well. On the other hand, the Latin American picture is dominated by the debt situation and it was the debt burden which made such a trade turnabout imperative. The magnitude of the trade swing is probably just about what was necessary to make the debt manageable.

What is the impact of the trade readjustment on the United States economy? In order to gauge other dimensions of the impact, we have introduced a trade swing of $23 billion (current dollars) into the Wharton Annual model of the US economy. The impact of the change in trade flows, summarized in Table 5 is approximately $65 billion in current GNP. In real terms the effect of $18.5 billion (1972$) or approximately 1.0 percent of GNP. This accounts for almost 800 thousand jobs.

Other dimensions of the impact are summarized in Table 5. Particularly notable is the effect on economic activity and employment in the primary metals, motor vehicle and miscellaneous manufacturing industries.

Had we stretched our baseline assumptions somewhat further, assuming for example, that Latin American growth had continued into the 1980s at the pace of the previous decade, we would observe a still larger trade swing and, of course, also a consequently larger impact on US economic activity. But such an assumption lacks realism, in that it would assume a continuation of lending to Latin America at the torrid pace of the 1979-81 period.

The impact of the financial flows is more difficult to evaluate, and we have not attempted to put a quantitative dimension on its effect. The lending to Latin America has diminished drastically. While limited lending has continued it dropped sharply to $14 billion of loans in 1984, compared to $56 billion in 1981. Thus, the supply of dollars on foreign exchange markets has clearly diminished. Interest payments increased tremendously with the growth of the debt and the increase in interest rates early in the 1980s. The expansion of the debt in recent years, has been largely offset by lower interest rates. In combination with improved trade balances the current account deficit of the Latin American countries is near balance. A substantial component of the forces influencing the dollar has been capital flight, recorded in the balance of payments as "Errors and Omissions". Anectodal evidence suggests that this problem has eased and should not exercise as much upward pressure on the dollar currently as it did during the past three or four years.

On balance the impact of the Latin American crisis on the dollar exchange rate is difficult to evaluate. Obviously, with respect to the bilateral exchange rates between the US and various Latin American currencies, the demand for dollars relative to the supply has pushed up the value of the dollar. This bilateral exchange rate relationship is already encompassed in the US-Latin American trade balance used in the computation discussed above.

Another issue is whether the situation caused the dollar to be high relative to other currencies as well to reduce the US competitive condition in third country markets and to affect US trade and economic activity. On balance it is not possible to provide an unequivocal answer. On one hand, capital flows have been generally toward the US. On the other hand, the precariousness of Latin American debts raised fears about the state of US banks, and that may have discouraged capital movement to the US. It is not clear consequently, whether the value of the dollar with respect to European and Japanese currencies has been affected, nor is there clear evidence of the effect on US interest rates.

As we have noted, the successive debt crises have been defused. Though there are significant arrearages with respect to several of the smaller countries and even with some of the large ones, outright defaults have been avoided. This has minimized the potential impact on the banking system though one should not assume that there has been no impact. We have noted the large value of holding of Latin American debt by US banks relative to their capitalization (from 100 to over 200 percent in some cases). On one hand, such figures exaggerate the risk, since there is no question of writing off 100 percent of Latin American debt. On the other hand, such figures do not account for the expectational impact, the fears of depositors and the possibility of a premium in interest rates as a result of the increased risk. However, such risk premiums appear to have been quite small so far. As we will note below the probability of outright default in the future is real but small. Nevertheless, such an event could have significant implications for the developed countries, a recession, and for the developing world, a long term reduction in their growth prospects. (For a discussion see Wharton Econometric Forecasting Associates, "What If Latin America Defaults?", Fall 1984, Philadelphia, Pa.)

Prospects for the Latin American Debt Situation

Last year was one of almost universal recovery in Latin America (though from a low level) with regional GDP growth of 3.3 percent and the first increase in per capita GDP since the beginning of the debt crisis (Table 6). The major countries showed surprisingly good balance of trade results and as a consequence the current account of the six major countries achieved a small surplus in contrast to the large deficits incurred in previous years. (The remarkable reduction in Brazil's current account deficit from $6.8 billion in 1983 to $0.7 million in 1984 was primarily responsible for this result.)

But it is important to note that domestic economic performance was still deficient in most of Latin America with high unemployment rates, per capita income some 9 percent below earlier peaks, and with runaway inflation rates particularly in Brazil and Argentina. The domestic performance of most of the countries remains far outside the bounds of the conditions proposed by the IMF. Nevertheless, the favorable element is that, despite the serious economic difficulties, progress toward political opening in the direction of popular democracy is still being made in many countries, particularly in Brazil.

Prospects are for some further improvement in the economic situation throughout Latin America, except next year in Argentina. For the region as a whole growth can be expected at 2.8 percent for 1985 and then at 4 to 5 percent annually for later years of the decade. Unfortunately, this projection falls considerably below the growth rate of the most favorable recent decades and does not recoup the welfare losses suffered as a result of the debt problem.

Whether one can say that the debt situation has been overcome is largely a matter of perspective. Default has been avoided and, with increased flexibility on the part of the lenders, it is likely that restructuring agreements will ultimately be reached with many countries. Admittedly, there are some real problems among the smaller countries which are already effectively, if not nominally, in default.

From another perspective however, we must recognize that the burden on the debtor countries countries to be a heavy one. The terms of trade have gone sharply against the debtors. In order to service their debt, the Latin American countries transfer over $30 billion annually to their creditors. While limited lending has continued in order to avoid defaults, traditional flows of capital from developed to developing countries have all but dried up.

From the perspective of trade and balance of payments, the slowing of exports from the major Latin American countries in the first quarter of 1985 suggests that the spectacular trade performance of 1984 will not be repeated. And the softness of oil prices promises to create additional difficulties for Mexico and Venezuela. On the other hand, the easing of interest rates is worth $3 billion for each percentage point of interest rate reduction and that is a favorable prospect.

Finally, with respect to the burden of the debt, we note that the ratio of interest payments to exports shows only little further reduction in the next few years. Our projection shows that, even in 1988, 39 percent of Latin American exports will go to cover the interest payments. Lower interest rates would, of course, be helpful in this regard.

What Can Be Done About It?

What then can be done about the problem? Are there any actions which will ease the threat of crisis or reduce the long term burden?

It is not likely that the debt situation will disappear quickly from the news. Even if default can be avoided, and that is our most probable outcome, there will be repeated negotiations, in themselves costly and disruptive. The resource cost for the developing economies of Latin America will continue. The debt overhang will affect Latin American growth for many years to come. The impact on the US trade balance and on US industries will remain for many years. There is considerable commonality of interest between the debtor countries in Latin America and the United States in resolving the problem.

We cannot simply wipe out the debt, but we can lend support to measures which will ease its burden.

It goes almost without saying that proper management of economic policy, so as to establish a healthy and growing world economy with realistic interest rates, is a basic requirement. The runup in real interest rates was a contributing factor to the debt problem. Much could be achieved with balanced economic policy: Easier monetary policy and reasonable, but not excessive, fiscal stimulus to set the world economy on a full employment growth path. Lower interest rates would ease the burden on the debtors; the growth of demand would provide markets for the products of the Latin American economies.

Other approaches include:

1. Increasing the flexibility of the IMF and of the commercial banks in dealing with debt crisis situations. This includes any measures which will facilitate and smooth over the process of debt renegotiation and avoidance of default. Additional funding for the IMF and other organizations involved in the rescheduling process would be helpful.
2. Stretch out the debt, reduce the instability of interest rates. The critical issue here is conversion of short term debt at variable interest

rates into longer term funding at stable, predictable interest rates. The need to lengthen maturities and to stabilize interest rates has been recognized in the Mexican rescheduling and will eventually be a part of other debt restructuring as well.

3. Distribute the burdens of more equitability on a "no fault" basis. The issue here is not to hold one party or the other responsible, but to recognize that the debt has become burdesome to both debtors and creditors. Steps which would reduce the rate of interest, perhaps by offering public guarantees and by issuing new preferential credits into which outstanding debt can be converted need to be considered.

It is time to evaluate the long term implications of the debt overhang and to take positive steps to tear down a barrier to world economic expansion.

TABLE 1

Latin American External Debt (Billions of U.S. Dollars)

	1979	1980	1981	1982	1983	1984
Argentina	19.0	27.2	36.2	38.3	43.6	46.9
Brazil	52.9	60.5	73.3	87.6	91.6	100.2
Chile	7.9	10.9	15.7	17.2	18.6	20.0
Colombia	6.4	7.5	9.0	10.3	11.9	13.3
Mexico	40.0	49.0	74.5	81.9	90.6	91.4
Venezuela	31.3	25.5	27.8	36.5	33.4	31.6
TOTAL	157.5	180.6	236.5	271.8	289.7	303.4
% Change	12.2%	14.7%	31.0%	14.9%	6.6%	4.7%

Source: Wharton Econometric Forecasting Associates, Latin American Economics Outlook, Fall 1983 and Spring 1985; F. Gerard Adams, E.P. Sanchez, and M.E. Adams, "Can Latin America Carry Its International Debt?" Journal of Policy Modeling 5(3): 421 (1983).

TABLE 2

Latin American Trade: Total Imports and Exports of the Six Major Countries

(Billions of U.S. Dollars)

	Exports	Imports	Merchandise Balance
1979	53.2	51.0	2.2
1980	69.5	68.9	0.6
1981	78.3	78.3	0.0
1982	72.0	60.2	11.8
1983	73.4	42.4	31.0
1984	82.3	45.8	36.5

Source: Wharton Econometric Forecasting Associates, 1985.

TABLE 3

U.S. Trade With Latin America (Billions of U.S. Dollars)

	U.S. Exports	U.S. Imports	U.S. Merchandise Balance
1979	26.3	24.8	1.5
1980	36.0	29.9	6.1
1981	39.0	32.0	7.0
1982	30.1	32.5	-2.4
1983	22.6	35.7	-13.1
1984	26.3	42.3	-16.0
Change: 1981-1984	-12.7	10.3	-23.0

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*Total U.S. Trade with twenty Latin American republics.

Source: U.S. Bureau of the Cnsus, Survey of Current Business, March issues, 1980-85.

TABLE 4

U.S. Trade with Latin American By Category of Merchandise[1]

(Billions of U.S. Dollars)

	1981			1982			1983			1984[2]		
	Exp.	Imp.	Bal.	Exp.	Imp.	Bal.	Exp.	Imp.	Bal.	Exp.	Imp.	Bal.
Food	4.9	7.2	-2.3	3.0	6.5	-3.5	3.7	6.9	-3.2	3.1	8.2	-5.1
Processed Materials	2.1	1.3	0.8	1.8	1.0	0.8	1.7	1.0	0.7	2.6	1.2	1.4
Fuels	0.8	13.7	-12.9	1.7	15.2	-13.5	1.0	15.4	-14.4	1.0	16.5	-15.5
Manufactures	30.4	9.9	20.5	22.5	9.8	12.7	15.5	12.4	3.1	18.7	16.5	2.2
TOTAL	39.0	32.0	7.0	30.1	32.5	-2.4	22.6	35.7	-13.1	26.3	42.3	-16.0

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[1] Total U.S. trade with twenty Latin American republics. Categories may not sum to total due to rounding.

[2] 1984 figures are estimated.

Source: U.S. Bureau of the Census, Highlights of U.S. Export and Import Trades, Report FT990, December issues.

TABLE 5

Effect of the Latin American Trade Swing on the U.S. Economy*

	1982	1983	1984
Gross National Product	-17.0	-46.0	-65.0
Real Gross National Product (72$)	-7.2	-16.5	-18.5
Employment (millions)	-.18	-.53	-.78
Unemployment Rate (%)	.16	.45	.62
Corporate Profits Before Taxes	-3.1	-9.4	-6.4
Net Exports	-6.1	-14.6	-16.4
Real Value-Added Output (72$)	-.72	-16.5	-18.5
Agric., Forestry and Fisheries	-.2	-.5	-.5
Mining	-.1	-.3	-.3
Manufacturing	-3.7	-8.6	-9.6
Durable Goods	-2.8	-6.3	-7.0
Primary Metals	-.4	-1.0	-1.3
Fabricated Metal Products	-.3	-.6	-.6
Machinery	-1.1	-2.3	-2.5
Motor Vehicles	-.5	-1.0	-1.1
Nondurable Goods	-1.0	-2.3	-2.6
Transportation	-.3	-.8	-.8
Commercial	-2.4	-5.5	-6.0

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* Figures are in billions of US dollars unles otherwise indicated.

Source: Wharton Econometric Forecasting Associates, 1985.

TABLE 6

Econometric Forecast for the Six Major Latin American Countries

(Billions of U.S. Dollars)

	1984	1985	1986	1987	1988	1989	1990
Exports	82.3	84.4	87.9	93.8	101.9	111.5	119.5
Imports	45.8	53.1	57.2	62.5	70.2	77.4	83.7
Trade Balance	36.5	31.3	30.8	31.3	31.6	34.1	35.9
Current Acct. Bal.	0.2	-3.8	-6.9	-11.1	-13.8	-12.6	-15.8
Total External Debt	303.4	305.1	310.7	319.7	332.4	342.2	358.5
Interest Payments/ Exports	0.44	0.38	0.36	0.38	0.39	0.36	0.37

Source: Wharton Econometric Forecasting Associates, Latin American Economic Outlook, Spring 1985.

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Representative OBEY. Thank you very much, Mr. Adams. Mr. Petty, why don't you proceed?

STATEMENT OF JOHN R. PETTY, CHAIRMAN, MARINE MIDLAND BANKS, INC.

Mr. PETTY. Thank you, Mr. Chairman; Senator.

In your opening statement, Mr. Chairman, you referred to a certain parallel emerging of thought with respect to Japan's surplus with the United States and Latin America's trade impact on the U.S. economy.

I didn't want to miss the opportunity to say that I don't see that a parallel exists, that, in the first place, the development of economic growth in Latin America has been an object of national policy in the United States and other countries over the years in terms of our development assistance program.

The second is that the yen is undervalued. I don't think of a Latin American currency that I can say that for.

Third, I think that Japan does not have a large foreign debt to repay. Indeed, it is equilibrating to the world's system to have Latin America settle, improve its exports. It tends to be destabilizing for Japan to have an excessive trade surplus absent that debt.

Fourth, Japan's export performance is what created that surplus.

And to a large extent, the fifth, I would say the Latin American import restrictions during the early periods of this adjustment crisis are contributing elements to that trade surplus.

That's a digression, sir, but I did want to make a point that came up.

In my prepared statement, which I will highlight as I walk through them, the United States-Latin relationship is both broader and deeper than most people realize. We were reading Rousseau and Voltaire 200 years ago, and gaining a common heritage of thought which has stimulated our aspirations for generations.

These traditions fostered common inspirations, which make up the prevailing sentiment within all the Americas.

Steadily, however slow each has been to recognize it, all of Latin America and the United States have reached a degree of independence, partly political, partly historic and cultural, strategic, and certainly economic. To be interdependent does not mean that each cannot, if it must, get on without the other. Rather, interdependence is a reflection that the overall interest of each is enhanced by a continuing, and even intensifying, relationship underpinned by a basic recognition of mutual responsibilities and respect. Such has long been the case for the United States with Canada and in recent years, it has become more so for our friends in Latin America.

For example, one trend now creating a quantitatively stronger linkage within the hemispheres, the unprecedented migration to the north, along with a sizable expansion in tourism. This traffic further serves to intermingle our cultural heritage and our social traditions.

Recent demographic figures bear this out. For other two generations, the dramatic growth of Latin America has added to the extraordinary mosaic which is the United States and from which our country has gained added vitality.

The benefits of this hemispheric relationship have grown as they have become fully two-sided, reciprocal, if not identical, advantages grow, unevenly, nation by nation, to be sure, but certainly they grow.

President Eisenhower's initiative in 1959 to create the Inter-American Development Bank, President Kennedy's Alliance for Progress, and President Reagan's Caribbean Basin Program reflect far more than political gestures. Chapultepec, the Rio Treaty, and countless bilateral efforts are expressions of succeeding administrations to reveal our mutual interests through increasing activity with Latin America.

Commercially, of course, these interests are reflected in a host of ways—from coffee and orange juice in the morning to tequilla in the evening, with a range of goods during the day. Altogether, we consume nearly $50 billion worth of imports from South America, representing nearly 2 percent of our disposable income and a higher percentage of our discretionary expenditures.

In the last 2 years, imports have surged with the strong dollar and the emphasis on exports in Latin America, all to the benefit of adjustment among the world economies.

Meanwhile, our exports to Latin America, while beneficial to our own expanding and dynamic economy, have suffered significantly for over 2 years—a result of the necessary, restrictive, and recessionary actions which inflationary, debt-ridden societies needed to employ temporarily. Our $12 to $15 billion export decline has hurt U.S. employment levels, and stands as one more reason why it is in our interest for these nations to regain sustainable economic growth patterns.

Tourism is another example of the growing cultural and economic flow between the United States and Latin America. While trade flows eclipse investment flows, the latter are still key ingredients to our economic relationship. Investment also has a major impact on the pattern of international trade, finance, and technology transfers.

Nonetheless, direct investments in Latin America are not always remembered fondly, either by investors or by many of the countries. The attitude toward foreign direct investment has been uneven when it has not been hostile, and investment growth in Latin America has been much slower than in other areas of the world.

The current environment, however, is more constructive. The prospects for the future might even be promising.

U.S. banks have loaned almost $90 billion to Latin American countries, while banks in other major industrial countries loaned $135 billion more. However, net new lending by commercial banks has dwindled to almost nothing.

The tables I have in the prepared statement reflect this shift.

Starting in 1982, as a result of the debt crisis, GNP growth rates in much of Latin America have plunged or turned negative. Per capita incomes have been adversely affected, as nations retrenched to put their economic houses in order.

To facilitate adjustment, Mexico, for example, suffered a per capita income reduction of over 20 percent. While some others have so far suffered less, all have recently foregone the growth critical to their aspirations and key to their greater welfare.

Emergency economic adjustment needs preempted immediate goals, a sacrifice necessary to best assure long-term growth. Politically, the equations involved near-impossible choices for the debtor countries. In each case, the long-term benefits of the people dictated the harsh choices of severe economic restraints. Yet, happy surprises sometimes appeared. Mexico's import restrictions proved an unexpected boon to small and medium-sized Mexican businesses as they responded to the need of supplying local industry and also increased Mexican employment far beyond expectations.

Adversity brings forth strengths, as its burdens fall unevenly.

The United States itself has also suffered from the debt situation. Formerly buoyant markets have contracted. Payments have been interrupted or stretched out many years. Losses suffered by South American companies and banks have also had an impact on U.S. investors. Finally, the efforts of Latin American countries to generate trade surpluses in order to service external debt have led them to devalue their currencies, making their exports more competitive with U.S. goods.

More specifically, the U.S.-Rio Grande border area suffered severely when its cross-border markets were restricted. The peso devaluation created substantial book losses on investments and defaults on loans, both of which resulted in tax-deductible losses.

Tourist bargains may have induced additional travel south, but many Latins were forced to abandon property in this country. The extent of the losses is as hard to identify as it is to quantify, reflecting the significant admixture of our economies.

To cite another example, even though frost harmed Florida citrus groves, U.S. consumers avoided major price increases at the breakfast table because Brazilian exporters stepped in to meet a major portion of our demand for orange juice. Bad luck to the Florida growers, but benefits to the Brazilian exporters and reasonable price stability to us as consumers.

Such is the interaction of our economies. Truly, we all benefit most in a general atmosphere of sound growth and reasonable price stability.

The major worldwide recession in 1981 bringing sharply declining commodity prices, a U.S. fiscal policy which has helped raise interest rates to extraordinarily high levels, were also chief contributors to the absence of enough foreign exchange to service much Latin American debt.

Lending by commercial banks, U.S. and foreign, grew substantially following the oil price increase of 1973 and 1979. As oil surplus countries deposited their sudden new profits in London and New York, the banks redistributed the funds as loans to world economies. This intermediation was the basic equilibrating factor in the world monetary system at the time.

Looking back today, we know that banks of the industrial countries were too eager to lend, and that foreign governments and foreign companies alike were too eager to borrow and press ahead with their growth. It is clear, too, that official capital sources—bilateral and multilateral both—did not have the resources to meet this type of demand. This was not just a matter of overreliance upon economic forecasts and misjudgment by financial people. Political leaders were not remote from the arena.

Moreover, this money was not wasted. The proceeds of the financing were constructively employed for the most part and will be repaid, although well beyond the dates originally intended. We lose sight of the fact that these resources were directed toward meaningful projects and that they also contributed substantially to the development of institutional strength, qualified people, and experienced organizations. To no small extent, their dividends are what make adjustment possible today.

In summary, bank lending provided for these countries ten years in which to build institutions and pursue economic growth after the initial oil shock. And, in my judgment, without the economic distortions in this country, combined with some poor planning and execution on their own part, more of the developing nations stood a very reasonable chance of missing the generalized debt problem.

Who is to say that the political risks occasioned by severe economic restraints today are more than what might have existed in the recent past, had the aspirations for growth in these countries not been strongly served by a rather aggressive development program aided by the large volume of bank loans?

In addressing the Latin debt problem, I find it useful to speak of its three stages:

Stage 1, the crisis, evoking a short-term response of payment delinquencies and political and economic adjustment by the borrower;

Stage 2, establishing a meaningful economic program with the requisite political support, earning the endorsement of the IMF, and the extended rescheduling of debt by lending banks;

Stage 3, the long-run reconstitution of the economy and a prolonged period of adjustment.

The depth of the adjustments in these distressed economies has not received widespread recognition. Their sacrifices through the burden of adjustment belie a sometimes popular image of profligacy. Mexico, for example, cut its budget deficit from 16 to 8 percent in one year, and has cut it more since.

But this is the cost of prolonged imbalances in an economy: the proverbial chickens coming home to roost. There is no alternative to the implementation and steady pursuit of a combination of fiscal, monetary, and foreign exchange rate policies appropriate to each nation. Countries must pursue their long-run development at an appropriate pace, and not be tempted by a quick-fix which will only lead to a relapse. Too often we forget that it was the tortoise that beat the hare. There is far more pain than glamor in balancing a budget, more pressure than applause in allocating limited resources. This latter is the day-to-day chore of leadership and management.

The driving development imperative of our times is the aspiration of people demanding necessities and seeking more—limited by the reality of economic development processes that are too slow.

The urge to move faster proves, recurrently, irresistable. The resultant distortions then require adjustment. Political leaders are caught between their reading of their people's needs and the good advice they receive about proceeding toward development in a measured way with a reasonable blend of monetary and fiscal policy.

It is my experience that intense crises breeds one of two reactions—compounded misunderstandings and graduated animosities, or a cooperative understanding fed by a commitment to work together toward the lowest cost solution.

In the present circumstances, the second and wiser path has been chosen—never easily, not always happily, but certainly. How else can one explain the Mexican initiative in April 1984 to provide the financial assistance necessary in the early stages of the Argentine program? Surprising, too, was the prompt and constructive response of Brazil and Venezuela. It was a major new event in intrahemispheric relations and, in fact, more noteworthy politically than economically.

So, my first conclusion is that the supportive, cooperative, "we are all in this together, let's work it out" attitude has been substantially enhanced.

Second, understanding in this country of the dilemma of the development—the twin realities I've just referred to—has improved and a high degree of cooperation is underway. Indeed, it is a vital ingredient for progress toward a solution.

Third, the debt rescheduling exercise has been truly extraordinary. Bringing together the thinking of hundreds of bankers from a couple dozen countries to bear on the particulars of a nation's development needs is an achievement, indeed. More significant, to have the conclusion reached by the bankers prove compatible with the borrower's perception of its own best interest—that is an achievement few may recognize.

Fourth, the process of reasoning through the issues together has served to underscore where the interests of each of us really lie—they lie together. Perceiving and understanding this can only enhance cooperation in the future.

Finally, the visceral reactions we all must have gone through at one point or another gave way to fair conclusions reached through serious consideration of the issues and the choices. Latin American countries themselves, after going through this crucible of crisis, have reevaluated where their interests really lie. One can only believe that the stage for increased cooperation in the future is well set. Thank you, Mr. Chairman.

[The prepared statement of Mr. Petty follows:]

PREPARED STATEMENT OF JOHN R. PETTY

The U.S. Relationship with Latin America

The Relationship: Extent and Nature

The extent of the United States-Latin American relationship is both broader and deeper than most people realize, and it becomes more so day by day. Two hundred years ago we, in all the Americas, were reading Rousseau and Voltaire, gaining the common heritage of thought which has stimulated our aspirations for generations. True, Danton and Robespierre were guides to some in South America and ignored to the North. True also, the ability to read, as Prescott has pointed out, was far more prevalent in the English-speaking colonies than in either the Spanish or Portuguese-speaking counterparts, but that only pointed to a different path toward political expression. Moreover, the inspiration of George Washington had its direct analog in Miranda, Bolivar and San Martin.

These traditions fostered common inspirations and similar aspirations which make up the prevailing sentiment within all the Americas. They have generated a considerable respect for alternative political and economic approaches to our hopes. Of course, there have been situations, sometimes recurrent, but always ephemeral, when that prevailing sentiment has been sorely challenged. By and large the ties that bind have proven much more enduring than anything which might separate us in our common purposes.

Steadily, however slow we each have been to recognize it, all of Latin America and the United States have reached a degree of interdependence: partly political, partly historical and cultural, strategic, and certainly economic. To be interdependent does not mean that each cannot -- if it must --get on without the other. Rather, interdependence is a reflection that the overall interests of each are enhanced by a continuing and even intensifying relationship, underpinned by a basic recognition of mutual responsibilities and respect. Such has long been the case for the United States with Canada, and in recent years it becomes more so for our friends in Latin America.

For example, one trend now creating a quantitatively stronger linkage within the hemisphere is the unprecedented migration to the North -- along with a sizable expansion in tourism. This traffic further serves to intermingle our cultural heritage and our social traditions. A quick -- if unscientific -- way to gauge how entwined these tradtions have become is simply to listen to a number of radio stations in New York or New Jersey, or in California or Texas or Florida. The blend of the hemispheres through the media intensifies this involvement.

Recent demographic figures bear this out. Today, 6.5 percent of the U.S population is Hispanic in origin. Yet only two decades ago Hispanic origin wasn't considered numerically significant enough to record in census data. Some 4.5 percent of our population is Spanish or Portuguese speaking today. And over the last decade, the annual growth rate for the Hispanic population in the United States has averaged 3.7 percent compared to 1.1 percent for the country as a whole. For over two generations the dramatic growth of Latin Americans has added to the extraordinary mosaic which is the United States and from which our country has gained added vitality. Far more significant than the economic impact of this growth is the more general recognition of what this increased Hispanic influence has to bring.

Benefits of This Hemispheric Relationship

The benefits of this hemispheric relationship have grown as they have become fully two-sided. Reciprocal, if not identical, advantages grow -- unevenly nation by nation, to be sure, but certainly they grow. President Eisenhower's initiative in 1959 to create the Interamerican Development Bank, President Kennedy's Alliance for Progress, and President Reagan's Caribbean Basin program reflect far more than political gestures. Chapultepec, the Rio Treaty, and countless bilateral efforts are expressions of succeeding administrations to reveal our mutual interests through increasing activity with Latin America.

Commercially, of course, these interests are reflected in a host of ways -- from coffee and orange juice in the morning to tequilla in the evening, with a range of manufactured goods during the day. Altogether we consume nearly $50 billion worth of imports from South America, representing nearly 2 percent of our discretionary income. In the last two years, imports have surged with the strong dollar and the emphasis on exports in Latin America -- all to the benefit of adjustment among the world's economies.

Meanwhile, our exports to Latin America, while beneficial to our own expanding and dynamic economy, have suffered significantly for over two years -- a result of the necessary, restrictive and recessionary actions which inflationary, debt-ridden societies needed to employ. Our $12 to $15-billion export decline has hurt U.S. employment levels, and stands as one more reason why it is in our interest for these nations to regain sustainable economic growth patterns.

Tourism is another example of the growing cultural and economic flow between the United States and Latin America. Travel by U.S. residents to Latin American countries has gone steadily upward in the last four years. In 1983 alone, for instance, more than half a million U.S. residents visited South American countries. In turn, more than a million South Americans visited the United States, and that figure does not include tourists from the Caribbean or Mexico. To the Department of Commerce, a visit to Mexico is the same as a visit to Canada, and it is not recorded as overseas travel. What all this travel means is an average of $10 billion annually in travel earnings.

While trade flows eclipse investment flows, the latter are still key ingredients to our economic relationship. International investment in new and improved capital stock is a significant contributor to world economic growth. Investment also has a major impact on the patterns of international trade, finance and technology transfers. It is important to consider, therefore, the impact of some $35 billion that U.S. businesses have invested in Latin America. While 20 percent of that was in the petroleum sector, almost half was in manufacturing and about 11 percent in banking.

Nonetheless, direct investments in Latin America are not always remembered fondly, either by investors or by many of the countries. Legend and circumstances may vary, but perceptions linger. The attitude toward foreign direct investment has been uneven when it has not been hostile, and investment growth in Latin America has been much slower than in other areas of the world. With the present generation of investments, which are not so heavily involved in extractive industries, and the far more sophisticated structuring and arranging of new investments -- not to mention more sensitive management -- the current environment is more constructive. The prospects for the future might even be promising.

Bank lending, obviously, is a different story. U.S. banks have loaned almost $90 billion to Latin American countries, with banks in other major industrial countries adding $135 billion more. This is substantially more than the $35 billion in U.S. investments, and clearly has been an important channel of funds for Latin investment. As the accompanying chart illustrates, however, net new lending by commercial banks has dwindled to almost nothing.

Outstanding Bank Claims on Latin America
(in billions of dollars)

	1981	1982	1983	1984
U.S. Banks	79	87	88	89
BIS reporting banks	197	215	220	226
U.S. Share	40%	40%	40%	39%

Annual Net New Bank Lending to Latin America
(in billions of dollars)

U.S. banks	12	8	1	1
BIS reporting banks	34	18	5	6
U.S. Share	35%	44%	20%	17%

All totaled, Latin American debt last year came to $350 billion, and interest payments on that debt were $37 billion. More revealing, however, is the cost of servicing the debt. Debt service payments were a substantial 39 percent of total Latin American exports of both goods and services. Interest payments themselves amounted to 29 percent of total exports.

Starting in 1982, as a result of the debt crisis, GNP growth rates in much of Latin America have plunged or turned negative. Per capita incomes have been adversely affected as nations retrenched to put their economic houses in order. To facilitate adjustment, Mexico, for example, suffered a per capita income reduction of over 20 percent. While some others have so far suffered less, all have recently foregone the growth critical to their aspirations and key to their greater welfare.

Emergency economic adjustment needs pre-empted immediate goals, a sacrifice necessary to best assure long-term growth. Politically, the equations involved near impossible choices for the debtor countries. In each case the long-term benefits of the people dictated the harsh choices of severe economic restraints. Yet happy surprises sometimes appeared. Mexico's import restrictions proved an unexpected boon to small and medium-sized Mexican businesses as they responded to the need of supplying local industry. Adversity brings forth strengths -- as its burdens fall unevenly.

Impact of the Debt Problem on the U.S Economy

The U.S. itself has also suffered from the debt situation. Formerly buoyant markets have contracted. Payments have been interrupted or stretched out many years. Losses suffered by South American companies and banks have also had an impact on U.S. investors. Finally, the efforts of Latin American countries to generate trade surpluses in order to service external debt have led them to devalue their currencies, making their exports more competitive with U.S. goods.

More specifically, the U.S. Rio Grande border area suffered severely when its cross-border markets were restricted. The peso devaluation created substantial book losses on investments and defaults on loans, both of which resulted in tax-deductible losses. Tourist bargains may have induced additional travel South, but many Latins were forced to abandon property in this country. The extent of the losses is as hard to identify as it is to quantify -- reflecting the significant admixture of our economies.

To cite another example, even though frost harmed Florida citrus groves, U.S consumers avoided major price increases at the breakfast table because Brazilian exporters stepped in to meet a major portion of our demand for orange juice. Bad luck to the Florida growers, but benefits to the Brazilian exporters and reasonable price stability for us as consumers. Such is the interaction of our economies. Truly, we all benefit most in a general atmosphere of sound growth and reasonable price stability.

Effect of the Debt Problem on the Financing System

Latin America has absorbed foreign capital since the last century, and from time to time there have been individual country problems necessitating rescheduling. That the current debt problem is more general suggests that it stems from more than just the policies of the borrowing countries themselves. Others besides bankers did not anticipate the economic develoments of the 1980's.

In fact, the major worldwide recession in 1981, bringing sharply declining commodity prices, and a U.S. fiscal policy which has helped raise interest rates to extraordinarily high levels, were the chief contributors to the absence of enough foreign exchange to service much Latin American debt.

The debt problem of developing countries in general -- and Latin countries are easily the largest portion - has had potentially major effects upon (1) the banking systems of various countries, both borroweres and lenders, and upon (2) the international monetary system.

Lending by commercial banks, U.S. and foreign, grew substantially following the oil price increases of 1973 and '79. As oil surplus countries deposited their sudden new profits in London and New York, the banks redistributed the funds as loans to world economies. This intermediation was the basic equilibrating factor in the world monetary system at the time.

Looking back today, we know that banks of the industrial countries were too eager to lend, and that foreign governments and foreign companies alike were too eager to borrow and press ahead with their growth. It is clear, too, that official capital sources -- bilateral and multilateral both -- did not have the resources to meet this type of demand. This was not just a matter of over-reliance upon economic forecasts and misjudgment by financial people. Political leaders were not remote from the arena.

Moreover, this money is neither all gone nor wasted. The proceeds of the financing were constructively employed for the most part and will be repaid, although well beyond the dates originally intended. We lose sight of the fact that these resources were directed toward meaningful projects and that they also contributed substantially to the development of institutional strength, qualified people and experienced organizations. To no small extent, the dividends are what make adjustment possible today.

In summary, bank lending provided for these countries ten years in which to build institutions and pursue economic growth after the initial oil shock. And in my judgment, without the economic distortions in this country, combined with some poor planning and execution on their own part, more of the developing nations stood a very reasonable chance of missing the generalized debt problem. Who is to say that the political risks occasioned by severe economic restraints today are more than what might have existed in the recent past, had the aspirations for growth in these countries not been strongly served by a rather aggressive development program aided by the large volume of bank loans?

In addressing the Latin American debt problems, I find it useful to speak of its three stages:

--Stage one...the crisis, evoking a short-term response of payment deliquencies and political and economic adjustment by the borrower.

--Stage two...establishing a meaningful economic program with the requisite political support, earning the endorsement of the IMF, and the extended rescheduling of debt by lending banks.

Stage three...the long-run reconstitution of the economy and a prolonged period of adjustment.

The depth of the adjustments in these distressed economies has not received wide-spread recognition. Their sacrifices through the burden of adjustment belie a sometimes popular image of profligacy. Mexico, for example, cut its budget deficit from 16 to 8 percent of GNP in one year, and has cut it more since.

But this is the cost of prolonged imbalances in an economy: the proverbial chickens coming home to roost. There is no alternative to the implementation and steady pursuit of a combination of monetary, fiscal and foreign exchange rate policies appropriate to each nation. Countries must pursue their long-run development at an appropriate pace, and not be tempted by a quick fix which will only lead to a relapse. Too often we forget that it was the tortoise that beat the hare. There is far more pain than glamor in balancing a budget, more pressure than applause in allocating limited resources. This latter is the day-to-day chore of leadership and management.

The driving development imperative of our times is the aspiration of people demanding necessities and seeking more -- limited by the reality of economic development processes that are too slow. The urge to move faster proves --recurrently -- irresistable. The resultant distortions then require adjustment. Political leaders are caught between their reading of their people's needs and the good advice they receive about proceeding toward development in a measured way with a reasonable blend of monetary and fiscal policy.

The Current Status of the Economic Relationship

It is my experience that intense crisis breeds one of two reactions: compounded misunderstandings and graduated animosities, or a cooperative understanding fed by a commitment to work together toward the lowest cost solution.

In the present circumstances, this second and wiser path has been chosen -- never easily, not always happily, but certainly. How else can one explain the Mexican initiative, in April of 1984, to provide the financial assistance necessary in the early stages of the Argentine program? Surprising too was the prompt and constructive response of Brazil and Venezuela. It was a major new event in intra-hemispheric relations and, in fact, more noteworthy politically than economically.

So, my first conclusion is that the supportive, cooperative, "we are all in this together, let's work it out" attitude has been substantially enhanced.

Second, understanding in this country of the dilemma of development -- the twin realities I just referred to -- has improved, and a high degree of cooperation is under way. Indeed, it is a vital ingredient for progress toward a solution.

Third, the debt rescheduling exercise has been truly extraordinary. Bringing together the thinking of hundreds of bankers from a couple dozen countries to bear on the particulars of a nation's development needs is an achievement in itself. More significant, to have the conclusion reached by the bankers prove compatible with the borrower's perception of its own best interest -- that is an achievement few may recognize. I think it's almost a miracle.

Fourth, the process of reasoning through the issues together has served to underscore where the interests of each of us really lie: they lie together. Perceiving and understanding this can only enhance cooperation in the future.

Finally, the visceral reactions we all must have gone through at one point or another gave way to fair conclusions reached through serious consideration of the issues and the choices. Latin American countries themselves, after going through this crucible of crisis, have re-evaluated where their interests really lie. One can only believe that the stage for increased cooperation in the future is well set.

* * *

Representative OBEY. Thank you, Mr. Petty.

Let me say before I begin on my questions that I think you misunderstood my point in my opening statement. I was not suggesting that there was somehow a series of parallel lines that you have underlying the causation of our trade deficit with Latin America versus Japan, for instance. The only point I was trying to make, and it's a very simple one, it is that these days, almost all of our attention is focused upon our economic problems with Japan. Outside of the occasional reference to what an individual government is doing in Latin America, there's very little attention being focused on the fact that there is a definite domestic benefit to be gained by our providing similar attention to the problems that we have in Latin America.

And the point I was trying to make is that to the extent that we focus upon "the Japanese problem," in quotes, as being the only major problem we have in terms of our own trade deficit, to that extent, we continue to ignore the real role that a healthy Latin America can play in expanding our own economic opportunity, something which I think Mr. Adams' statement spelled out quite clearly.

Mr. Adams, in that regard, Senator Proxmire has often asked the question here of other witnesses, including Ms. Norwood from the Bureau of Labor Statistics, she is often asked the question, how many jobs have we lost because of our trade deficit situation?

You have made an attempt to quantify the job loss that we are experiencing because of Latin America's troubles. How do you arrive at the figure that you use in your testimony?

Mr. ADAMS. Well, in this case, what we did was really rather simple. We began by looking to see how much of a swing there was in that trade balance, the same kind of number that you referred to in your opening statement.

Then we argued that that's at least one indication of the kind of swing that was necessary in order for the Latin American countries to meet their debt obligations, make the interest payments on their debt, effectively, bring their current account balance back into some equilibrium.

And then what we did was we simply introduced that kind of an adjustment into the trade numbers of the Wharton Econometric model. This is a very large, very complex model of the U.S. economy. We recognized, to some extent, the composition of these imports and exports. We made the adjustments in the appropriate categories. And then we allowed the model to operate. We compared the result that we obtained to a base solution which didn't have these adjustments and we found that with that kind of an adjustment, we lost almost 800,000 jobs.

Now, that really is a result of spinning the whole system. There are multipliers that operate. There are specific industrial impacts that operate. But that gives us an approximate measure of what the impact is throughout the whole economy.

Representative OBEY. I don't suppose that your model enables you in assessing the impact in terms of job loss, I don't suppose that model enables you to tell us where those jobs have been lost, except as you indicated in your statement, that that job loss has occurred primarily in the manufacturing sector.

Mr. Adams. We do get some breakdown by———

Representative Obey. By "where," I meant geographically.

Mr. Adams. But geographically, we do not. That would be a tough job. You really need a much more complex system than we have here to do that.

I think that there are two kinds of impacts. Mr. Petty made the very valid point that we can see some of that impact directly in those areas along our southern border for instance, that connect with Mexico. It's immediately apparent there.

But what this work suggests is that that impact is more widespread in the United States, that it hits the automotive industry where it's located and other miscellaneous manufacturing industries, which means an impact which extends beyond the border areas throughout the whole country.

Representative Obey. Let me ask a question. We've all been assuming that economic—and I'd like both of you to answer the question—we've all been dealing with assumptions, whether we're trying to pass a budget resolution or look at other questions, we've all been dealing with assumptions on economic growth which appear to be somewhat higher than those which we're likely to experience over the next year

If the United States—I gather, Mr. Petty, you feel that if the U.S. economy continues to grow at 3 percent or more a year, that that would be sufficient to avoid a resurgence of the Latin debt problem.

What if the U.S. economy were to grow over the next year or two at the 2.2 figure which has been recorded over the past three quarters? How significantly would that exacerbate the Latin American problem and what variables would you have to look at in determining whether or not it would be a significant problem?

Mr. Petty. I've generally thought that the 3 percent is, indeed, a rate of growth in the industrialized countries which would permit normal equilibrating factors to take place; 2.2 is at the lower end of that range. It would be compensated somewhat, I imagine, by a lower interest rate and maybe by some secondary growth generated by a lower interest rate.

You could conceivably offset that eight-tenths of 1 percent GNP growth—I'll defer to Professor Adams on this—but something on the order of 3 or 4 percent interest rate reduction in terms of capital flows for Latin America.

So I would postulate that a 2-percent or 2.2-percent growth rate would have a lower interest rate environment than some of the models have now been forecasting and that that would mitigate the adverse impact significantly, if not substantially.

My concern is if the growth is not even 2 percent. There, indeed, I think is a scenario for which I have no final act and that would be much more difficult for adjustment.

Representative Obey. What if the interest rates did not decline to the degree to which you would postulate?

Mr. Petty. Clearly, the cheese would bind.

Representative Obey. I mean, there are pressures on the Fed both ways.

Mr. Petty. There are, indeed, and one of them is the concern that we all share that if the lesser developed world does not have the capacity to service its debt. How that's weighed by the Fed open market committee vis-a-vis the other elements, I'm not sure, but it would be an important factor just as our strong dollar is an important factor.

Representative **Obey**. Mr. Adams.

Mr. **Adams**. I would largely support what Mr. Petty has said, that there is, after all, a significant element of tradeoff. As the economy softens, there will be an impact on interest rates and, to some extent, that will offset the trade impact. One could make an attempt to quantify that.

But there is something of a complication in that, which is that the exports of Latin America are not only demand-driven, but they are also, to some extent, supply-driven. The exchange rates in Latin America will continue to drop if needs for foreign exchange aren't met. This won't have an immediate impact, but I suspect that exchange rate adjustment in terms of trade adjustment will allow them over a period of time to continue to export even if the world economy is going somewhat more slowly.

Indeed, if they can't continue to export and if the banks are not willing to provide additional credits under those circumstances, then we are on the high road toward default.

I don't think that will happen. I think, most likely, even with a slowing economy, they'll find it more difficult to export, and they have to export at even more adverse terms. But they'll do their damnedest to continue to do so. Frankly, I think, as we look at our banks, we may be tempted to do our damnedest to enable them to do so because if they don't export, they're simply unable to meet their obligations.

Representative **Obey**. Senator Proxmire.

Senator **Proxmire**. Thank you, Mr. Chairman.

Mr. Petty, you're chairman of the Marine Midland Banks and it's great to have you and this distinguished expert from Wharton, Mr. Adams, here as a panel. You're a fine panel for this panel, and I'm sure for many other purposes, too.

I'd like to ask you first, Mr. Petty, what prospects, in your judgment, there are for Argentina? As you know, Argentina has had a 1,000-percent inflation in the last year. That means that if you were making $20,000 a year, that by the end of the year, that would be worth about $2,000. In other words, it's absolutely devastating, a tremendous effect on that economy.

Your general conclusion for the Latin American countries, by and large, is highly upbeat and optimistic, and it was very welcome, coming from an expert like you. But President Alfonsin has asked the Argentine congress to give him what seems to me to be a textbook-perfect cure for inflation. It's very similar to what the Germans did after World War I. It consists, as you know, of a pay-as-you-go fiscal policy. It would be a drastic, wrenching change for that economy, because they printed money for 25 percent of their expenditures.

And then he also proposes a series of sharp spending cuts as part of that fiscal policy, especially in military spending, a series of tax increases, legislation that would require a fixed—forced savings, I should say—from high income Argentinians, wage-price controls, and a 1000:1 revaluation of Argentine currency.

The New York Times on Saturday reported that there was very, very powerful opposition to this austere program, including the opinion of economists and bankers that it was too much. One economist, I think, said it was like giving a cancer patient chemotherapy, drugs, and x-ray treatments all in the same day, and a feeling that it would totally collapse the economy.

Now my questions are, first, will Alfonsin get his way? Second, if he does, will the program work? And—well, then I have another followup question on that.

First, will Alfonsin, in your judgment, get his way?

Mr. **Petty**. Senator, you've shown your characteristic capacity to go to the heart of the matter and ask the toughest question.

It's a political choice that the president of the country is making, and I can't second-guess that. Whether cutting inflation from 20 percent a month to 8 percent, he had the opportunity 15 months ago, 16 months ago when he came into power, and he chose to go a little bit slow. In my last meeting with him, he made clear the point that—I think his phrase was, "Bringing inflation down under control has proved much more difficult than I originally anticipated."

He came into that office, frankly, I think, unprepared for the assignment of reorganizing the economy of Argentina. He had won an election which he hadn't expected to win and the next thing he had to do was to reorder the economy and do that in 60 days. And they didn't. And he was forming some new alliances with the Paranistas, or a new restructuring of the Paranista influence, and he was at the same time committed to the program of sending the military back to the barracks.

He is assessing again how much authority he has in the country at this time. A banker can advise what to do, but the choice has to be the political leader of that country. I simply can't guess that. I'm sure he's confident that he can do it; otherwise, he wouldn't make this choice. That it has risks, there's no doubt. No doubt.

Senator **Proxmire**. In your view, can it work?

Mr. **Petty**. This is the type of program that can work. This is the type of program that will work. They had three reorganizations of the Argentine economy in the last decade or two, the same general type of program where they had to bring down the share of the government in the economy, which, by the way, had a very large percentage of the transportation and railway industry consuming those large de[illegible], and a strong opposition toward changing the featherbedding practices in parts of the industry. And they've tucked away at it. He's taking another hard program.

I think it can work because the basic resources in the country exist, because the institutional strengths are strong, and I think, in the last analysis, the alternatives are few.

Senator **Proxmire**. Well, the part of it that seemed to be the shakiest was the proposed wage-price controls. You see, they tried that in Argentina before and it didn't work there. We tried it here, of course. It worked in World War II, but it hasn't worked, except under war conditions. They don't have war conditions now. They say the labor unions are opposed to it. Much of the business community is opposed to wage-price controls, and the experience has been bad.

Mr. **Petty**. And how long it lasts and how you phase it in to the post-price freeze environment is critical.

Senator **Proxmire**. Do you think they could succeed if they don't get wage-price controls? Are wage-price controls essential?

Mr. **Petty**. I think it's essential to have an announcement in effect within the entire economy that he means business, that things really have to be dealt with in an aggressive way. Wage freezing is not a long-term solution. Wage freezing can only be a short-term device for a transition to a more enduring system.

Senator **Proxmire**. How will this affect United States trade with Argentina?

Mr. **Petty**. In the short term, it will certainly hurt it; in the longer term, as they're successful, and I think they can be and will be, it will help, although most of Argentine trade is with Western Europe, relatively less with the United States. We compete together for wheat, in particular, and they're underselling us in the wheat market today.

Senator **Proxmire**. How about the ability of Argentina to repay its debts, including the debts to American banks?

Mr. **Petty**. I think they'll demonstrate that capacity, Senator. The numbers, relative numbers at different points in the past are not substantially different than what they were at earlier crises. The difference here is it's a more general problem.

It's a problem this time as it has been in the past that Argentina and the leadership reflects sufficient confidence in their program and their results, that capital held by Argentines abroad will be repatriated. So the capital flight problem or holding their reserves overseas, they'll be encouraged to bring it back into Argentina. And that will be a major ingredient of their increased debt service capacity.

Senator **Proxmire**. Mr. Adams, how do you assess the effects of this program on the Argentine economy?

Mr. **Adams**. I think it's very difficult to forecast. I go along with pretty much everything that Mr. Petty has said. The critical issue is the degree of confidence and support that Mr. Alfonsin has.

Senator **Proxmire**. That seemed to be what the New York Times article focused on. They seemed to imply that it was unlikely, possible, but unlikely, that he would get the support he needed.

Can you give me any assessment as an expert on that, or do you think it's just something we'll have to wait and see?

Mr. **Adams**. No, I feel not sufficiently close to give an assessment of that. I suspect it's a little difficult to say, anyway, on the basis of past history because this does seem to be, in a sense, sort of a first positive step, the only step, I think, that Argentina could take to set things right.

Senator **Proxmire**. Mr. Petty indicated that there's a likelihood that the first effects may be adverse and in the long run, it would work out. The question is would they have staying power.

The first effect is to throw people out of work and to depress the economy and businesses fail and so forth. It's very, very hard for a congress, the Argentine Congress, in this case, to stay with the program. And the question is, as the inflation has been so bitter and so cruel, do they recognize that they've just got to take their medicine, as painful as it is?

Mr. **Adams**. I agree with that and want to simply say that it's a very difficult one to call in the case of Argentina.

Senator **Proxmire**. Let me ask you, Mr. Adams, and I'd like Mr. Petty to comment, too. If the U.S. trade position with Latin America improves, say we swing from an adverse balance of $16 billion, which it was in 1984, according to the figures that you provided. Won't that have an adverse, even a crushing, effect on the economies of Latin America as it goes from $16 billion adverse to a balance of trade so that they don't have that $16 billion payroll balance? And don't the Latin American countries desperately need the foreign exchange engendered by their favorable balance of trade to pay interest on their foreign debt, including their debt, of course, to our banking institutions in this country?

Mr. **Adams**. I think the answer to that is yes, and I think that's how we all can interpret the difference between the trade disequilibrium between the United States and Latin America and the United States and Japan.

There's no question in my mind that if the situation is to be handled, we must continue, and we will continue, a trade deficit with Latin America.

In the long run, we have to ask ourselves whether there are ways of easing out of this situation—perhaps lower interest rates, larger flows of capital toward Latin America, things like that. But in the short run, there's no question. The only way in which these debt obligations are going to be met is if Latin America exports more than it imports.

Senator **Proxmire**. As far as Argentina is concerned, Mr. Petty pointed out that much of their trade is with Europe. So that might not affect us directly. Mexico, of course, it's the other way. And, in general, I presume that much of their trade is with us, then, unfortunately, we can't have it both ways. We can't have a favorable balance of trade without it having an adverse effect on their ability to repay our debt.

Isn't that right, Mr. Petty?

Mr. **Petty**. I quite agree with that and, I think, it is important to disaggregate Latin America because the trade patterns of countries and the debt service problems are quite different by country. But in the aggregate, I agree with Professor Adams.

Senator **Proxmire**. I just have one other question. Mr. Adams, in your prepared statement, you say that you expect improvement in the economic situation throughout Latin America, except in Argentina—no, I guess that's not it. Where is it?

[Pause.]

Senator **Proxmire**. Here we are. Some industries are badly injured by foreign competition and they've called for an overall 20-percent increase on tariffs on all goods coming into the United States.

That's an appealing and attractive proposal to many people because the tax, in the first place, wouldn't fall on Americans, although, ultimately, it would be higher prices. But it wouldn't fall on Americans and it would help, at least in the short run, jobs in this country.

Let me ask you first, Mr. Petty, what will such a policy have on Latin American economies in their debt crises if we applied it just across the board, 20 percent, regardless of the country?

Mr. **Petty**. I think it would be a brutal slap in the face. When we have this commonality of interest, we have an interest really in having Latin America work out of its debt problem, and when they want to work out of it, which is what they do through exports, to restrict their access to our markets, it would be contrary to our total policy. It would be short-term bad for the U.S. consumer, it would be medium-term bad for the U.S. consumer, it would be long-term bad for the U.S. consumer.

I hope we do just reject outright such restrictions. They'd have a way of compensating for it by their exchange rate, for example, as well, which would probably fuel more inflation and be counterproductive if they overdid it.

Senator **Proxmire**. I think that's my time.

Representative **Obey**. That's all right.

Senator **Proxmire**. One other question. My time is up, but the chairman has generously allowed me to ask it.

Mr. Adams first and then Mr. Petty.

Today's New York Times reports that the World Bank may guarantee a portion of loans Chile would get from commercial banks. Brazil and Paraguay have received similar loans. A spokesman for the Center for International Policy, an institution that monitors human rights, says that the loan guarantees would be used by Chile's President Pinochet, and I quote, "to tell his military that he can increase repression without risk of losing vital foreign support."

Would you comment on the problem of economic support for oppressive governments?

Mr. **Adams**. I personally think that the political questions greatly complicate the economic questions here. I imagine that there are people who are split between a concern for the repressive policies of Mr. Pinochet and the desire to improve economic relationships between us and Chile and to improve the well-being of Chilean citizens, which has been disastrously hit in the past few years.

I don't know how to reconcile those alternative objectives.

I do think that, in principle, the idea of providing in appropriate places some guarantees so that the flow of commercial credit will continue and continue at moderate interest rates is a good idea. But I don't know how to resolve the political and economic complications.

Senator **Proxmire**. Mr. Petty.

Mr. **Petty**. In the first place, the report that I saw is new to me and one of the things that I want to do this afternoon is learn more about it. I'm surprised by it. I would assume that, upon further investigation, it would pertain to incremental lending and not certainly prior loans rescheduled.

Second, I think the World Bank is the tool of economic development and in its charter and the treaty that creates it and everything else, it is not to be an instrument of political policy.

I think the aggressive steps we must take against the Pinochet government and their repressive policies should not be pursued through multilateral lending agencies, but through the political channels, and that the long, steady road we have toward economic development and building up the infrastructure where the individual aspirations can be achieved can't be turned on and off by each morning's headlines.

Senator **Proxmire**. Well, they can't be turned on and off by each morning's headlines, but doesn't it depend on the degree of repression and how extensive it is and so forth? It seems to me if we have a human rights policy, the one reliable, nonmilitary action we can take is to use our great economic capability.

And if we overlook that, aren't we condoning repression?

Mr. **Petty**. We have many objectives. In Chile, for example, one of which is for economic development in the country. A second one is to stop repressive government. The third is to move toward popular democracy as soon as possible.

Do we abandon one and forget the other, or go after one and abandon the other two momentarily? Or do we pursue a balanced program of driving toward these three objectives, recognizing that if you were to analyze each step from 11 to 12 in the afternoon, it may not be consistent with the other ones.

I think, basically, it is in our interest to shore up the economy, help them help themselves, and the economic faucet-turning has not, of itself, been an effective tool toward achievement of political ends. But it has been an affective program in creating improved welfare in that country.

So I would vote for using our administration, through normal executive branch actions, to foster the changes that are going on and must be advanced in that country.

Senator **Proxmire**. Thank you, Mr. Chairman.

Representative **Obey**. I would like to follow up on the question that Senator Proxmire was asking earlier because, frankly, I was a little disconcerted with the response that both of you provided. And maybe you meant it. Maybe you want to do that. But I would doubt it.

My impression from your response to Senator Proxmire's earlier question is that you gave the impression that—you said we ought to disaggregate Latin America's trade situation, separate it out from Japan's. It's different. They need it in order to be able to pay back their debt.

My concern is that that seems to leave the impression that we have no alternative except to continue that trade deficit with Latin America for the foreseeable future, that there really isn't a hell of a lot that we can do about it if we want to see Latin America continue to grow.

I think that was the impression that I got from your response. But isn't it true that if we had a different mix of fiscal policy and monetary policy in this country, if we had a tighter budget, lower deficit, which would allow the Feds to be more relaxed in their monetary policy, isn't it true that that would ease the Latin American debt problems and at the same time ease our dollar valuation problems so that we could perhaps have a better world on both ends of the trading stick, with them being able to provide less of their resources to repay old loans and with us having a better opportunity to export because of the improved dollar situation on the part of our own currency?

Mr. **Petty**. Yes, sir. I think my response was in the short-term-time framework. I believe, given net capital flows and the current environment, adverse or neutral to Latin America, without their having an export surplus in the short term, 1 year or 18 months ahead, it is difficult to see how they would earn the capacity to service their debt.

Representative **Obey**. Yes.

Mr. **Petty**. I would hope with the better domestic economic policy of the United States, a better interest rate environment and growth, that there would be restitution of at least some type of capital flows, including direct investment, which I would think is not absurd to think will be a major factor in the future.

Then it's possible—Chile, for example, could have—the United States could have a trade surplus with Chile, but Chile could have a trade surplus with Western Europe, and Asia, and, in total, through their copper exports, for example, have a trade surplus to service it.

So if we looked at it bilateral for this country, that was my point, by disaggregating it with the Senator, that we could have a trade surplus in one case and maybe not in another, or when that country has a worldwide surplus.

Representative **Obey**. Mr. Adams.

Mr. **Adams**. Well, I'd be the first one to agree with you that a different mix of policy would make a difference. I do think we need to ask ourselves whether, over a longer time perspective, there isn't something that we should do in order to restructure that Latin American debt, to stretch it out over a long period of years, to try to reduce the interest rates, and even at some cost to us. A more stable debt, more assured of repayment, is a gain which we might be willing to offset with somewhat lower rates of interest.

And, finally, I agree that once Latin America is back on reasonable health, we could see more capital flow. And ultimately, we would probably see a multilateral trading world where we aren't constantly buying more from Latin America than we are selling them.

But trade is, in part, at least, north-south in the Western Hemisphere and, as a consequence, it may well be that the United States will have a bilateral deficit with respect to Latin America and, hopefully, a bilateral surplus with respect to other countries.

Representative **Obey**. Let me ask Mr. Petty—in light of Mr. Adams' suggestion about something further being done about that long-term debt, I think I know what you're going to say, but, nonetheless, I'll ask the question.

You have a lot of people who are saying, not just in the Congress, but out, that we're really fooling ourselves, that these debts really aren't going to be repaid long term. There may be an effort made now and a very admirable one, to try to repay them, but that overhang is a long one and a heavy one, and that, really, in the end, we're going to be lucky if we can just keep this ball rolling in the air and that we really aren't going to see banks get back that money.

That's a devil's advocate question. Respond to it any way you want to. But, I mean, are we really fooling ourselves? Do we really have a Rube Goldberg approach going on here, pretending that we're going to, that those debts are going to be eventually repaid?

Mr. Petty. I think, Mr. Chairman, 2 years ago, at somewhat similar hearings on Eastern Europe, I got the questions about the world coming to an end, the sky was falling, and that the capacity for Eastern European countries to reduce their obligations. And talking about the generalized debt problem in the world, they felt that, you know, you just had to wipe it all off and start anew.

But I think events have shown that that's not what you have to do. I think what you have to do really is to encourage those countries to develop the type of economic program that's sustainable, that the lenders themselves must work with them and make the concessions from normal lending policies that they do only when they have to, and that the system will adjust over time, and that the type of rescheduling we've done in some countries—and here I remind Professor Adams that having an 8-year grace period on principal and 6 years from year 9 through 14 for principal retirement, is a very substantial debt rescheduling, and once again, an adequate concession. And I think that's deserved because the countries have shown a capacity to meet their—a will to repay their debt and a commitment to establish their economic house in order, if you will.

So I am not discouraged. I'm disappointed that it hasn't happened faster. But we don't live in that type of world. I think this debt will be repaid and I believe we can manage this in a manner that is consistent with those countries achieving their own long-term development objectives.

Representative Obey. Well, let me follow up on that. Obviously, right now, we are looking at the situation from the vantage point of a time in which the situation has certainly been looking rosier than it was 2 years ago. The question is is it looking rosier than it might look 3 years from now.

You say that what is necessary is for these countries to establish a repayment program that is sustainable and all of that. We have the question of what's sustainable economically. We also have the question of what's sustainable politically.

When I wear my other hat, I'm chairman of the Subcommittee on Foreign Operations of the Appropriations Committee, and my ranking member is Congressman Kemp. Congressman Kemp has spoken at great length about his concern about the political pressures that this repayment puts on people like Mr. Alfonsin, for instance.

His program sounds terrific now, sounds serious now, sounds determined now. But what happens in 4 months, 6 months—Lord knows how long—what happens if people say, forget it, baby. We're not going to sit in the dentist's chair for that long—without novocain. We're going to look for some relief. And what happens if you start having—what happens if you have one explosion or two down there that says, to hell with it. We ain't going to do it.

Aren't we really—I won't say closer to it—but don't we really have more of a likelihood that we're going to face that with one, two, three countries than we might think if we simply look at it in terms of the way the world is looking right now, today?

Mr. PETTY. Well, Congressman Obey, we're full of uncertainties. You're asking a question to which there are no clear answers.

In the fall of 1982, when the new Mexican program was being formulated just upon the inauguration of the new President, the type of limitations and cutbacks in budget, everybody said, it's not possible that the Mexican economy is going to react adversely and it won't hang together.

One of the reasons that I emphasized in my prepared statement the institutional strength that has developed in Latin America and the political leadership that's needed to make this pay off is that's really where the answer to your questions lay. Who, for example, would have imagined 4 months ago that the newly elected President of Brazil would not be with us right after that, when he had just fired the imagination of his country and developed a team to lead an aggressive economic program to bring the house in order?

But, yet, we see that the people he designated and the new President are working hard to fulfill that commitment.

I think there's this recognition that you can't cheat Santa Claus, that you've got to develop an economic program that is sustainable over time and that's the best way to increase the welfare of your people.

I think that message is understood. It's never liked. It's never easy. It's not without its uncertainties. And I'm sure we're going to have more crises. I'm not quite sure where they're going to occur, but I'm very convinced that the players in the game recognize where their interests lay, recognize the advantage of working their solutions out together, and they're going to deal with them.

Representative OBEY. Well, I'm struck by the differences between the program announced by Mr. Alfonsin recently—cold turkey, hard, quick, get it over with quickly—and the Israeli approach to dealing with their economic problems. I don't know how familiar you are with that. I think there are two questions that come to mind in terms of what will work economically, which model—the Alfonsin model or the more cautious incremental approach being taken by the Israelis, is likely to be economically effective?

And also, the other side of the question—which of those models is likely to be more politically sustainable? The theory behind the Alfonsin approach is you get it over fast, you try to make your actions dramatic enough so that people can begin to experience the benefit sometime more quickly than they would if the pain were gradually inflicted. You have the other concern being whether or not any government that institutes that kind of program can stick around long enough to see it through.

I don't know if you have any observations on that.

Mr. PETTY. It clearly is a contrast. Of course, Alfonsin does not have a coalition government and the role of the military figures differently in Tel Aviv than it does in Buenos Aires. And I think that those are key ingredients of different political equations that each of the leaders of the countries are dealing with.

And I think it's true that the Israeli Government had a lot of very direct, outside, bilateral assistance from the United States to pick up some of the check in foreign exchange terms that Argentina has not had.

President Nixon sent me to Buenos Aires in 1971 to tell the President of Argentina that we were not going to give him any money until he had his own economic house in order. As a special ambassador, that was not a happy message to carry.

Similar trips aren't quite taken to the Middle East because of the whole configuration of the Middle East situation. And that's part of the equation, too.

Representative Obey. Well, I would say that this administration, I think, has worked pretty hard to try to convey to the Government of Israel that they aren't going to just let loose the money purse without some real action. There have been some other pressures that events, as well as politics, have brought on them in that regard, which are unfortunate.

Let me ask you, because you're frankly much more optimistic than I am about the Latin American situation—at least I think you are.

How long do you think it will be before we see a significant return to voluntary lending on the part of financial institutions to Latin America?

Mr. Petty. This will be selective, Mr. Chairman. In Mexico, beginning over 1 year ago, there was a modicum of voluntary lending on trade transactions. In a country such as Peru, I don't think it's on anybody's calendar, and you would sort of have to address each situation in each country. Clearly, the commercial banks would look first toward trade transactions, whether it's to finance U.S. exports or Latin exports of a 3- and 6-month normal trade transaction basis. And that would be minor in numbers.

It is encouraging to reestablish the commercial confidence for further trade and significant in that sense, but not in significant numbers in aggregate capital flows.

I think you're going to see in some countries, again, Mexico, first because they received with the crisis first and dealt with it most rapidly and are further along, the question about the direct investment. I don't see Mexico changing their direct investment laws, but I do imagine that they will be administering them with more flexibility than they have in prior years. And I can well imagine that Mexico will be viewed in a happier light as a direct investment source. Tourism fostering, notable examples.

I would think the question is being considered as Brazil presently has a law which permits bank loans—Brazilian obligations resulting from bank loans to be converted to finance direct investment. Some direct investments are now being considered, some is being done. I'm looking at some myself, which would shift the structure of the liability and convert it into a direct investment.

There's no way to quantify how significant that's going to be attitudinally. It certainly is significant.

Down the road, if 3 or 4 years from now there's world growth and the economies are looking on the up, it is well within the imagination of investment bankers in the marketplace to see other ways to stretch out and to finance Latin American debt.

I would anticipate that happening if there is that growth and sustained prospect of recovery. I can't say when; I can't say exactly how it will be done. But, clearly, there's a whole host of able people in New York and London who make a living doing that and the market place will, the marketplace could accommodate that.

Representative **Obey**. Mr. Adams, do you have any comment that you want to make on that question?

Mr. **Adams**. No; I think that's a complete answer, coming from a banker, probably one that's more authoritative than the one that I could give.

[Laughter.]

Representative **Obey**. I have two or three other questions that I'd like to ask both of you, which I'll just give you. You might want to respond for the record to flesh out some holes here.

Let me ask you—do either of you have anything else that you'd like to say?

Mr. **Petty**. No, I appreciate the chance to speak, Mr. Chairman, though.

Representative **Obey**. Nothing?

[No response.]

Representative **Obey**. All right. Thank you both very much. The committee stands in recess.

[Whereupon, at 11:45 a.m., the committee recessed, to reconvene at 10 a.m., Friday, June 21, 1985.]

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THE IMPACT OF THE DEBT CRISIS ON THE U.S. ECONOMY

FRIDAY, JUNE 21, 1985

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to recess, at 10 a.m., in room 2359, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey and Scheuer; and Senator Proxmire.

Also present: Don Terry, Democratic staff director; and Kent Hughes, Sandra Masur, and John Starrels, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative Obey. Good morning. Let me explain first that we are probably going to have a vote very quickly, and if we do, I'll have to leave. And I'll be back as quickly as I can. Let me simply say that before we hear testimony this morning, that the international economic situation for the United States is anything but bright.

In 1983, we suffered a merchandise trade deficit balance of payments of $61 billion. If you add in the cost of the insurance and freight, the 1984 deficit rises to $123 billion on a CIF basis.

On Tuesday, the Commerce Department announced the United States has become a debtor nation for the first time since World War I, and we have seen a number of projections indicating how long it will take before we pass Brazil as the world's No. 1 debtor nation.

The list of current American trade problems is long and growing. Most of our attention has been focused, however, on the uncompetitive dollar, the competitive challenge of Japan. Today marks the second of three hearings on an often neglected question—the impact of the Latin American debt crisis on U.S. exports and employment in the U.S. financial system.

This past Monday, the committee received some sobering testimony from Prof. Gerard Adams of the University of Pennsylvania and Wharton Econometrics. According to Professor Adams, the $7 billion surplus with Latin America in 1981 became a $16 billion deficit by 1984, a $23 billion deterioration in just 4 years.

Over the same period of time, our bilateral trade with Japan deteriorated by just over $18 billion and we lost some employment as well as we lost exports.

Mr. Adams calculated the loss to be somewhere in the neighborhood of 800,000 jobs in 1984. Among the markets affected by the Latin debt crisis has been construction equipment and farm implements. The problems have extended beyond manufacturing to effect some of the most competitive service industries as well.

Construction activity and, therefore, business for U.S. engineers, architects, and oversea builders has declined as a result of slow growth in the region.

To help demonstrate that the loss of jobs and lost exports are not just an economic abstraction, we have invited two prominent businessmen whose companies have extensive economic ties with the Latin American market. And I am pleased to have with us here this morning Mr. John Stevenson, vice president of J.I. Case Co., and the president of J.I. Case Credit Corp. J.I. Case is headquartered in my own State of Wisconsin, although not in my district.

We call Milwaukee and points south of that the Deep South where I come from. And I'm also very pleased to have Mr. Jack Richards, vice president of Kellogg Rust, a major oversea builder. Mr. Richards is also chairman of the action group of the International Engineering & Construction Industries Council. And I did not know this, but Mr. Richards tells me that he was born in Madison, WI. I'll not hold that against you. [Laughter.]

But I am happy to have both of you here. That was a bell which just rang and so I will leave at this point to vote and be right back. I have read both of your prepared statements and so I know what you're going to say, but if each of you would proceed to summarize your statements for about 10 or 15 minutes, I would ask Senator Proxmire to take over while I retreat and vote.

Senator **Proxmire** [presiding]. Thank you very much, Mr. Chairman.

Mr. Stevenson, we are honored and delighted to have you here. You are a constituent of mine. I don't know if you're a constituent of Dave's or not. I suppose you have so many employees in the State, some of them undoubtedly are. But we are very happy to have you with us and honored. You're a great company and do some fine work and I want to hear everything you say. Please go ahead.

STATEMENT OF JOHN L. STEVENSON, VICE PRESIDENT, J.I. CASE CO., RACINE, WI, ACCOMPANIED BY MICHAEL MOE, GENERAL MANAGER, INTERNATIONAL SALES FINANCE

Mr. **Stevenson**. Thank you very much. I'd like to introduce my colleague, Senator, Mr. Moe, who is our general manager of international sales finance.

Senator, members of the committee, my name is John Stevenson, vice president of J.I. Case Co., and president of the J.I. Case Credit Corp. We are indeed very pleased to have been asked to present our experiences to this committee regarding the negative effect that the country debt has had on our ability to export. We do thank you for this opportunity.

The J.I. Case Co. was founded in Wisconsin in 1842, is a worldwide leader in the manufacture of agricultural and construction equipment. We are the second largest manufacturer of construction equipment in North America and the third largest worldwide. With the acquisition of International Harvesters' agricultural division, we are the second largest manufacturer of agricultural equipment in North America.

The majority of our products are manufactured in nine locations in the United States for worldwide distribution. In addition, we have manufacturing plants in England, France, Germany, Spain, Brazil, and Australia. The J.I. Case operations employ approximately 17,000 worldwide, down from over 28,000 in 1980. With the acquisition of International Harvester—and I hasten to add, the numbers I just gave you were prior to the International Harvester acquisition, which took place on February 1. With the acquisition of International Harvester, our current employment is 23,400, of which 14,239 are in North America.

By State, total employment in Wisconsin is 3,800; in Iowa, 1,870; in Illinois, 2,300; in Indiana, 590; in Oklahoma, 330; and in Kansas, 170. In addition, we have over 4,000 employees in marketing, parts supply, and support services throughout the United States.

For J.I. Case, not including International Harvester, the 1984 worldwide sales were over $1.7 billion, down from a high of $2.4 billion in 1979. International sales, which traditionally have been from 35 to 38 percent of our total sales, dropped to 21 percent in 1984.

Our U.S. export sales, excluding shipments to Canada, which we treat as part of our North American operations, have declined from a high in 1981 of $168 million to $86 million in 1984, a 49-percent decrease. The 1985 shipments are down an additional 25 percent on an annualized basis.

More specifically, U.S. export sales to the marketing territories of Asia-Pacific, Africa-Middle East, and Latin America have declined steadily since early 1981 by some 59 percent. Latin America alone has declined 68 percent since 1980.

LATIN AMERICAN DEBT

Let us move now to a discussion of the question at hand—the international debt problem and its effect on U.S. exports, especially Latin American debt and its effect on J.I. Case.

We have all heard and read the reasons given for the 1982 to 1983 country debt crisis; sharp increases in interest rates, major drop in export and commodity prices, commercial banks and export credit agencies sharply cut back their lending and support.

During 1983, 30 countries rescheduled their loan agreements with the IMF and commercial banks; 17 countries requested the Paris Club to reschedule their official debt. In the 1983 to 1984 period, there was discussion of a debtors cartel and the possible repudiation of debt. Recently, we have seen new signs of the lingering debt problems with bank failures and new requests for further reschedulings. Internally, at the Case Co., we review regularly our country exposure and sales achievements by region. Not surprisingly, we find our problems center in the same 30 or so countries, primarily in Latin America.

During the past 2 years, a number of the major debtor countries have made significant progress for resolving their debt problems. They have made improvements in their trade account balances, increasing their exports while curtailing imports, enabling them to make debt service payments. Ironically, however, as Mr. Adams told this committee on Monday: "The United States stands at the flip side of this improvement," since the bulk of Latin American trade is with the United States and significantly in the manufacturing sector.

Therefore, action taken by these countries, the so-called austerity measures, actually hamper if not prevent our ability to export into those markets. Actions such as increases in the import tax, which can range from 20 to 25 percent in Latin America, the complete closing of the borders for certain products unless it is locally manufactured, requirements for barter or countertrade in order to import, and 150-percent deposit requirement in order to obtain an import license.

In addition to these direct restrictions there are other disincentives such as the favorable treatment given to products manufactured within the Latin American region. These may be imported at lower duties and with subsidized financing, such as from Brazil, Argentina, or Mexico. Those U.S. exporters without local assembly are shut off from these markets. Fortunately, we have a Brazilian plant but it produces only a limited construction equipment product line and, thus, we are restricted from many markets.

The countries of Latin America had been traditional markets for the Case Co. in both agricultural and construction equipment. We extended the normal terms of the trade offered by the industry, short-term financing to dealers during a floor plan period, with the flexibility to roll over or convert to medium term if needed to support a retail sale, and, of course, if the creditworthiness of the buyer warranted. Export credit insurance agencies developed the programs around these terms and provided commercial and political risk coverage subject to country and by eligibility. During the period of growth in these countries in the late 1970's and the recycling of the petrodollars, continuing sales and collections allowed dealers to service their debt.

But, then, along with other economic problems, as interest rates rose and bank lending was shut off, country liquidity was severely pressured. More importantly, local bank liquidity and various government actions and restraints severely hampered the ability of private buyers to borrow locally.

In some countries, foreign exchange moratoriums were officially imposed such as Mexico or, in others, such as Venezuela, where there were unofficial restrictions but virtually no dollar availability.

And, of course, the accompanying massive devaluations when dealers and retail customers saw their dollar get increased two, three, and four times its original value. It was during this time that much was written about the massive country debt problems and impending financial crisis. But most of the discussions centered on the public sector debt to commercial banks and official export credit agencies. Rarely was mention made of the private sector debt due to suppliers such as ourselves, who had always provided a large part of the trade financing needed by these countries.

For the most part, we have had to wait until the public debt to commercial banks has been negotiated and rescheduled. Trade debt has been given second or even third priority, or we find ourselves, a private foreign company, negotiating with a private local company for a rescheduling of their debt, companies who, for their very survival, demand long terms, cash settlements at a fraction of book value, forgiveness of late interest and below market refinancing rates.

If equipment was involved, many times we were forced to repossess it, if we legally can. Even then, it usually cannot be reexported to the United States or any other country. And of course, the value of that repossession is much less than the total that is due us. Many times, we have no choice in the refinancing. We are forced to operate under Government mandated long-term refinancing—5, 10 years in some cases.

Some may comment that the problem is one we created ourselves. Admittedly in some cases, that may be true. However, we mention this to point out that we suppliers also have large amounts owing to us. Unfortunately, we do not have the same amount of influence on the debtor that commercial banks and export credit agencies have with the public sector. But yet we realize that if we want to protect our outstandings and maintain presence in a particular market, we must accept these negatives, provide long-term refinancings to our customers, while in many cases granting additional credit to keep them operating and maintain the market presence.

It means that we must offer creative financing packages which keep further political and commercial risk to a minimum, while waiting for a government to lift the moratorium on dollar payments for previous shipments such as in Venezuela or Argentina.

Or it may mean that we must accept Government issued long-term bonds and payment of debt. Paper which we have to hold to maturity unless we are willing to take a very deep discount and sell to a third party.

We would like to point out that our company is not unique in these problems. Other U.S. companies in our industry can attest to similar debt and negotiation problems in Latin America. There are times, of course, when we may not be willing to take additional risk for any reason. In this and every case, we first pursue commercial bank financing or credit insurance cover for the buyers. But as you can well expect, these institutions are unwilling to increase their exposure to a country with which they have severe payment problems. It is for these countries that we rely on the financing provided by the international development banks and the U.S. AID. For many countries, funds provided by these agencies is the only way through which they can purchase needed products and spare parts and the only way we can make the export sale.

The strength of the dollar was undoubtedly restricted U.S. exports. However, we have no doubt that for our company the Latin American debt problem has been the major deterrent.

To summarize—obstacles for our export sales efforts are: Heavy debt burden has forced Latin American countries to maintain direct and indirect restrictions on imports; high tariffs to discourage imports of new equipment; import substitution is heavily encouraged if not required; export-oriented industries are emphasized; severe shortage and restrictions on dollar availability; double- and triple-digit inflation and continuing devaluations; emphasis on barter and countertrade, usually for nontraditional export products; and local bank credit availability is very restrictive.

What can be done?

As a company, we will continue to maintain a presence in all the Latin American markets. Prudently, we will continue to provide financing support in the major markets without credit insurance for support, if necessary. We expect the economic recovery process in Latin America to be long term. But we must continue our presence or lose markets which will take years to recover.

What can the U.S. Government do?

Develop monetary and fiscal policy which will lower interest rates to ease the debt burden on debtors.

Continued support for the U.S. export credit agencies; namely, FCIA and Eximbank.

Continued funding of the multilateral lending institutions.

Develop a trade policy which exporters can look to for consistency, a policy which at the very least is not a disincentive to our export efforts. Thank you very much.

Representative **Obey** [presiding]. Thank you, Mr. Stevenson. Mr. Richards, why don't you proceed?

STATEMENT OF JOHN C. RICHARDS, VICE PRESIDENT, KELLOGG RUST, INC., THE SIGNAL COMPANIES, INC., ACCOMPANIED BY ABRAM E. HOFFMAN, PRICE WATERHOUSE, ON BEHALF OF THE INTERNATIONAL ENGINEERING AND CONSTRUCTION INDUSTRIES COUNCIL

Mr. **Richards**. Thank you, Mr. Chairman. I am Jack Richards, vice president of Kellogg Rust Co., an international engineering and construction company group with world headquarters in Houston, TX. We are one of the Signal Companies and soon to be, we believe, part of a larger corporation known as Allied Signal.

I am representing the International Engineering and Construction Industries Counsel—IECIC. We are delighted to be here and have the opportunity to talk a little about the impact of the debt crisis on our engineering-construction industry.

Before going further, I would like to introduce my colleague from Price Waterhouse, who has been the project leader of a very interesting report sponsored by the IECIC. It has the purpose to establish the size and nature of the AEC—Architect Engineering Construction industry—and to measure the secondary effects these exports have on the U.S. economy.

I have not been able to put in the prepared statement approximate information on several of the LDC debt laden countries in our company experience. I have since been able to obtain some approximate information which, if you should desire, I can provide for you.

Representative **Obey**. Sure.

Mr. **Richards**. IECIC was established in 1967 when our industry recognized the serious problems causing the erosion of the U.S. competitive position in our industries. We believed these problems and mutual interests could be best dealt with under the umbrella of IECIC thereby providing a collective contact with the Congress and Federal agencies, financial institutions, and the private sector.

We are composed of four major associations—the American Consulting Engineers Council; the American Institute of Architects, representing a large number of professional architects; and the Associated General Contractors composed of some 8,500 general contracting companies and the National Constructors Association consisting of 40 of the largest U.S. firms with nearly half a million employees engaged in the design, engineering, and construction of major industrial facilities throughout the world.

As an association today, IECIC represents some 4 million AEC employees in the United States. Our total contribution to the U.S. gross national product was approximately $230 billion gross revenues or over 7.5 percent of the total. This figure is higher than the contribution of other major industries. For example, petrochemical is only 6 percent; banking, 5; and transportation and communications is 6.5. In 1982 our contribution was very much lower than it was in the previous 20 years when it averaged something like 9 and 10 percent.

In the 1970's as multinational companies took advantage of expanding farm markets and cheaper productive resources abroad, there was a large increase in investment in oil refineries, chemical, and petrochemical processing plants, and this was fueled and substantially expanded our engineering construction business.

The importance of this market increased markedly in the 1970's because at the same time, particularly in the late 1970's, there was a large overall decline in domestic project awards.

In the early 1980's, the worldwide recession, however, combined with the slowdown in revenue growth of oil exporting nations caused a leveling off and more recently a sharp decline in international construction activities. Continuing worldwide inflationary pressures and high interest rates have restricted further the ability of many nations to finance new projects. This has caused a sharp drop in industrial development and expansion in both developed and developing countries, many with large amounts of long-term external debt.

As a consequence, the industry has a greatly reduced business volume, resulting in a loss of jobs and revenues to the U.S. economy.

In June 1984, we engaged Price Waterhouse to undertake a study defining and measuring the benefits to the U.S. economy of AEC exports. We have, as an industry, been concerned with the liability of data published on the performance in the international sector. The principal private source is the engineering news record which compiles reports annually on the volume of oversea business. But it has many deficiencies, not the least of which is that awards are reported by each company participating in a project thus double-counting exists between prime or managing contractors.

Finally, awards do not represent the net U.S. revenues from AEC exports.

The Government studies of our industry concentrate more on theoretical or policy implications, not on economic impact. Commerce Department studies rely heavily on ENR data and are therefore suspect.

The Price Waterhouse survey covering the years 1982 and 1983 was designed to overcome these difficulties. It was administered to a representative sample of AEC industry firms and the results projected to the entire export industry.

The overall response was excellent. The international firms account for 76 percent of known revenues stemming from foreign construction projects and 62 percent of known revenues from foreign AEC projects.

I think you will be interested in the following brief review of the significant findings of the study. We have included in our prepared statement as appendix A, a more detailed executive summary of the report. It shows that the AEC industry had export revenues in 1983 of approximately $19.6 billion of which $4.8 billion represents direct U.S. revenues. The total 1983 export revenues were more than $2 billion lower than in 1982 and U.S. export revenues decreased by $800 million from the previous year.

What's more important, the biggest reduction was in the materials and equipment sector which declined by $900 million from 1982 to 1983.

The significant results are that this $19.6 billion generated an additional $6.1 billion domestic revenue. For every billion of direct revenues produced by these AEC exports, there's an additional $1.27 billion of indirect revenues from associated sales of goods and services and employment. Total employment was 261,000.

We established in the study that every $1 billion in total revenues generated by these exports results in approximately 24,000 jobs. I should add that this is on the low side. It represents AEC as opposed to manufacturing. We think that manufacturing on its own is probably higher than that.

Total U.S. wages resulting from the AEC exports in 1983 were $6.3 billion and total Federal, corporate, and personal income taxes resulting from these AEC exports were $1.13 billion.

Last, AEC exports supported $1.4 billion in contracts to U.S. subcontractors and the purchase of $1.9 billion in U.S. materials.

We are particularly pleased with the results, and you can see that the value of the AEC industry in 1983 produces $11 billion in both direct and indirect revenues and provided employment for 261,000 U.S. personnel.

In our prepared statement, we have suggested that the committee should address the international competitive issue of our industry as it has a pronounced impact on the U.S. economy. It is not directly related, I will concede to the principle purpose of this hearing, but it does have a relevance to the action of our Government that affects our future ability to obtain business. Government action to reduce the Federal deficit, for example, to improve the strong-dollar relationship with other currencies is an essential, and the removal of federally imposed disincentives such as unfavorable tax arrangements and other restrictive conditions. On these we ask for your support.

I'd add here that the heavy debt burdens of the debtor countries have been eased considerably in recent years by the financial support from multilateral development banks—the World Bank, the Inter-American Development Bank, and others. They deserve, we feel, increased support from the U.S. Government which is the key to additional financial support from other developed countries.

The potential benefits of the United States and the world economy of this industrial and infrastructure development is immeasurable. This country and the world needs the support of the Congress and the administration for this increased funding.

In our industry today, this seems to be about the only game in town—the World Bank and the Development Banks. Particularly in the developing world there is very little funding available, as I am sure you all know.

Briefly, I would like to add that the most important disincentive or disadvantage to our industry is the lack of competitive export financing of the Eximbank. My colleague, Mr. Stevenson, has stressed this in his testimony as well. He also has mentioned the importance of the World Bank funding. Even as we speak, Mr. Chairman, the House-Senate Budget Conference is meeting to consider, among other items, the elimination of the Eximbank direct credit authority.

We feel that should this program be terminated that our industry as well as U.S. manufacturers will be severely handicapped in their export efforts.

I would like to conclude now with a summary of our industry views on what the future holds for our competitiveness on AEC international major projects.

I'd like to at the same time acknowledge to the committee the contribution made by the Department of Commerce in their competitive assessment report, July 1984, and I am advised by them that they intend to issue this report again in July of this year. And it will include the results of our IECIC-Price Waterhouse study which we have discussed.

The future demand for our international services and the consequent impact on the U.S. economy will depend largely on the economic strength of the world and international economies, our national construction needs and the capabilities of developing countries to carry out projects on their own.

Until the worldwide recession eases and debt servicing and high inflation continue to affect the Third World, we do not forecast an improvement in major international construction projects in the next 2 or 3 years.

Moderate growth may be expected through the late 1980's and through the 1990's, and it should occur in all geographic regions. Of course, this projection assumes no major economic collapse, major acts of war and moderate economic growth worldwide.

Now, we are going to find that developing countries will continue to increase their capability to undertake construction projects on their own and this will shrink the volume of business available to us, the U.S. firms.

On the other hand, large and technologically sophisticated projects should continue to be available to U.S. firms. It is clear, however, that the levels of competition in all market segments will be intensive and the competitive environment for U.S. firms will be very difficult.

The future U.S. international industry competitiveness and our ability to continue our strong contribution to the U.S. economy, we believe, will depend on the following four major points:

We would have to sustain technical and project managerial leadership on major nonlabor-intensive projects; competitive financing assistance through Eximbank and other financing institutions as appropriate must be maintained; we must ease or remove several government disincentives to successful U.S. participation, which are the key to successful U.S. international participation in the AEC market; and we must continue the highly favorable reputations of major U.S. firms for reliability, performance, and effective management of large and complex projects, which American companies are famous for.

That is the completion of my oral remarks. If you care to, I would be happy to talk about some very rough estimates we made of projects deferred in Latin America and one other country that were not available to us at the time of the prepared statement.

It's difficult—there are so many factors involved in this equasion of assessing what the impact is on our industry of debt problems. There are such things as the strong dollar, the shortage of hard currency, the intensive foreign competition and the lack of export finance, and others.

We can go on at some length. However, with this Price Waterhouse study, I think we can say that when AEC business is either unavailable or has been postponed, or lost to the foreign competition, the loss to our economy is definable in a sense of knowing what the direct and indirect loss of revenue is to the U.S. economy.

It's difficult to put an accurate number to it; however, we have looked at specific situations in three or four countries in Latin America where my company has been active and we have been able to or attempted to identify in an approximate way projects that had been planned prior to 1980, for the 1982 to 1986 period, but were deferred, we think for ostensible reasons because of the debt crisis.

The countries looked at are Argentina, Brazil, Mexico, and Nigeria. Essentially, all of our AEC business has dried up in these countries, principally because, and mostly because of the hard currency being used almost entirely to service debt.

About the only business potential our industry has seen over the past 3 or 4 years is associated with possible compensation, trading arrangements through local joint ventures and own and operate type projects with hard currency being supplied for these projects from abroad.

For example, my company is now developing a methanol project in Chile along these lines. Moreover, these countries are undertaking expansion work through existing facilities using local engineers and equipment supplied from local sources.

This is particularly true in Argentina and Brazil. As a rough estimate, I would say that our company business in Latin America has dropped on the order of 75-85 percent from the mid-1970's. That is before the debt crisis reached us in the early 1980's.

Argentina, in the oil and related gas industry sector, for example, such plants as liquified natural gas, liquified petroleum gas, refinery modernization and expansion in the fertilizer industries, we believe as much as $8 to 10 billion in AEC project values have been postponed over the past 3 or 4 years.

If we assume the U.S.A. could obtain about one-quarter of this business, the loss to the U.S. economy using the Price Waterhouse equations would be roughly $1 to $1.25 billion or 24,000 to 30,000 jobs.

Brazil is in a difficult situation because they have virtually no oil or gas reserves, as you know. Thus, it's very hard hit by the big oil price increases in the late seventies and early eighties, in addition to their debt problem. There were a number of large hydroelectric thermal power plants planned there. There was coal gasification and a number of refinery modernization projects—expansion projects—and we believe that some $12 to $14 billion in these projects has been deferred over 2 to 3 years at least because of the financial problems. Using the same assumptions that we did for Argentina, this relates to a loss of total revenues of about $1.5 to $1.7 billion to the U.S. economy, and 36,000 to 42,000 jobs.

In Mexico, in 1980, Mexico's petroleum monopoly, PEMEX, planned to spend $16.5 billion in plant and equipment by 1980 through 1986. In the expansion—this was to be in the expansion of the oil production, oil refining and petrochemical facilities. A combination of factors such as lower crude prices and debt burden caused a deferment of roughly two-thirds, we believe, of this expansion.

That is roughly $11 billion. Most of this was in the processing area. They have continued to expand in the oil production and exploration. In Mexico, the U.S.A. traditionally gets about half of this market and accordingly a loss of total revenues to the United States economy would be about $2.25 billion total revenues and 54,000 jobs.

Nigeria is a country we have been active in and are now doing a very large fertilizer complex there. They have a serious debt problem, as you know, and several major projects have been deferred—a large energy project, a major refinery and chemical facility have been deferred.

There estimated total value is thought to be about $7 billion, which at a 25 percent probability award rating to a United States engineer contractor equates to a revenue loss to the U.S.A. of $880 million and 21,000 jobs.

I thank you, Mr. Chairman and Senator Proxmire, Mr. Hoffman and I will be pleased to answer any questions you have on our statement.

[The prepared statement of Mr. Richards follows:]

PREPARED STATEMENT OF JOHN C. RICHARDS

IMPACT OF LDC DEBT CRISIS ON THE ARCHITECTURAL, ENGINEERING AND CONSTRUCTION INDUSTRY

Mr. Chairman and Members of the Committee:

My name is Jack Richards. I am a Vice President of Kellogg Rust Inc., an international engineering and construction company with world headquarters in Houston, Texas. We are one of the Signal Companies and expect in the near future be a part of a larger corporation to be known as Allied Signal. I am here today as the Chairman of the Action Group of the International Engineering and Construction Industries Council (IECIC). In addition, I represent the National Constructors Association where I presently serve as Chairman of the International Affairs Committee. We welcome this opportunity to meet with you today to present our views of the effect on our industry associated with the financial problems of debt-laden countries.

IECIC was established in 1967 when our industry recognized the serious problems causing the erosion of the USA competitive position in the architectural, engineering and construction community overseas. We believed these problems and mutual interests could be dealt with most effectively under the umbrella of IECIC, thereby providing a collective contact with the Congress, federal agencies, financial institutions and the private sector concerned with development projects abroad.

IECIC is composed of four major associations involved in international engineering and construction work: The American Consulting Engineers Council (ACEC), the professional engineering society representing 3,800 firms and 120,000 members; the American Institute of Architects (AIA) representing 41,000 professional architects; the Associated General Contractors composed of some 8,500 American general contracting firms and 32,000 associated firms involved in heavy construction projects such as dams, large commercial buildings and highways; and the National Constructors Association consisting of 40 of the largest U.S. firms with nearly half a million employees engaged in the design, engineering and construction of major industrial facilities throughout the world. These contracts include "turnkey" projects such as oil refineries, steel mills, petrochemical and chemical plants. My own company is now heavily engaged in the construction of three major projects overseas: a fertilizer complex in Nigeria, an aromatics project in Indonesia and an LPG and LNG gas processing facility in Western Australia.

IECIC today represents directly some four million architectural, engineering and construction (AEC) employees in the United States. In 1982 the estimated total contribution of our industry to the U.S. GNP was approximately $230 billion or over 7.5% of the total. This figure is higher than the contribution of other major industries; for example, petrochemical is 6%, banking 5% and transportation and communications is 6.5%. The AEC industry contribution in 1982 was much lower than the previous 20 year average of between 9 and 10%.

The international AEC market experienced a general expansion in the 1970s as multinational companies took advantage of expanding foreign markets and cheaper productive resources abroad. A large increase in investment in oil refineries, chemical and petrochemical processing plants and other major projects fueled this expansion, and LDC's, particularly those with oil and gas resources, participated in this industrial expansion. Therefore, the importance of this international market to U.S. AEC companies increased markedly in the 70s because of the overall decline in domestic project awards.

The early 1980s worldwide recession, however, combined with the slowdown in revenue growth of oil-exporting nations have caused a leveling off, and more recently, a sharper decline in international construction activity. Continuing worldwide inflationary pressures and persistently high interest rates have restricted further the ability of many nations to finance new projects. This has caused inevitably a sharp drop in industrial development and expansion in both developed and developing countries, many with large amounts of long-term external debt at high interest rates. As a consequence, the U.S. AEC industry today has a greatly reduced business volume, resulting in a loss of jobs and revenues to the U.S. economy. While it is not possible to assess accurately the magnitude of this loss of business attributable solely to the long-term debt problems of many countries, we are able to analyze with reasonable accuracy the direct and indirect impact of this loss of revenues to the U.S. economy when off-shore AEC business is not obtained.

In June 1984, IECIC engaged Price Waterhouse to undertake a study defining and measuring the benefits to the U.S. economy of AEC exports. The purposes of the study were: 1) to establish the size and nature of the AEC export industry, and 2) to measure the secondary effects these exports have on the U.S. economy in the form of revenues, employment, taxes and in the extent of U.S. materials and services purchased.

At the outset of the study work, the consultant confirmed the industry view that very little data collection and statistical analysis was being performed by government or private sources on the size of the AEC export industry, or on the direct and indirect effects of the industry on the U.S. economy. The principal private source of AEC export industry data, the Engineering News Record (ENR), compiles and reports annually data on awards of contracts for overseas work. As a basis for estimating the volume of overseas business and the impact on the U.S. economy, awards data suffer deficiencies. For example, a contract award will generally cover work undertaken over several years. Moreover, awards are reported by each company participating in a project, thus double-counting exists between prime or managing contractors or parent companies and subsidiaries. Finally, awards do not represent the net U.S. revenues from AEC exports.

Government studies of our industry concentrate more on the theoretical or policy implications of AEC exports, not on their economic impact on the U.S. economy. Low industry response rates, reporting entity complexities and terminology confusion raise questions as to the validity of the results. Commerce Department studies published frequently as the "Competitive Assessment" or in "Industrial Outlook" rely heavily on ENR awards data and are therefore suspect as to the accuracy of overseas business volume. The Bureau of Census studies are subject to significant delays between data collection and publication so that their data loses much of its effectiveness.

The Price Waterhouse survey of the AEC industry covering the years 1982 and 1983 was designed to overcome the difficulties of the government and private sector studies mentioned above. The survey was administered to a representative sample of AEC industry firms, and the results projected to the entire AEC export industry. Price Waterhouse was solely responsible for receiving and compiling the survey responses, thereby encouraging a higher response from participants and maintaining the confidentiality of individual firms' sensitive commercial information. It is of interest to note that the overall survey response rate was 60% of all of the firms sampled, with a 40% response of the firms classified as international. These international firm responses account for 76% of known revenues stemming from foreign construction projects and 62% of known revenues from foreign architectural, engineering and construction projects.

I think you will be interested in the following brief review of the significant findings of the IECIC study of the AEC industry. Attached to this testimony as Appendix A is the Executive Summary of the formal study with Exhibits I, II and III which will provide a rather more detailed explanation of the size of the contribution our export industry makes to the domestic economy. The complete study is now being printed in volume and will be available for distribution within the next few weeks.

The study shows that the AEC industry had export revenues in 1983 of approximately $19.6 billion of which $4.8 billion represents direct U.S. revenues. Total 1983 export revenues were more than $2 billion lower than in 1982, and U.S. export revenues decreased by $800 million from the previous year. The largest reduction in 1983 took place in the materials and equipment sector which declined by $900 million from the 1982 level.

Other significant results show that in 1983:

- An additional $6.1 billion of domestic revenues were generated as a result of AEC exports.
- For every $1 billion of direct revenues produced by AEC exports there is an additional $1.27 billion of indirect revenues from associated sales of goods and services, employment, etc.
- Total U.S. employment resulting from AEC exports was 261,000.
- Every $1 billion in total U.S. revenues generated by AEC exports results in approximately 24,000 jobs.
- Total U.S. wages resulting from AEC exports were $6.3 billion.
- Total federal corporate and personal income taxes resulting from AEC exports were $1.13 billion.
- AEC exports supported $1.4 billion in contracts to U.S. sub-contractors and the purchase of $1.9 billion in U.S. materials.

IECIC is pleased with the results of the study which demonstrate firmly that from the standpoint of the U.S. economy, the AEC industry in 1983 had a value of $11 billion, it employed 261,000 U.S. personnel and, in addition, generated over $1 billion in federal corporate and personal income taxes. When debt-laden countries are not able to expand their industrial base with the U.S. AEC industry, it is clear that the loss to the U.S. economy is substantially greater than the direct U.S. revenue. The additional domestic revenues generated as a result of AEC exports are a significant boost to the U.S. economy.

A related problem faced by the AEC industry in seeking business internationally in developing countries is the competitiveness issue, which we believe should be addressed by this Committee as it has a pronounced impact on the U.S. economy. To be successful in the international AEC markets, firms need to convince their clients that their services will be competitively priced and equal to or better than the foreign competition. In most cases, a contract award is based not only on price, but in consideration of many other factors. Major items common to most markets in the current competitive international environment include price, quality, technology, management capabilites, experience, export financing, exchange rates and U.S. government disincentives.

I would like to discuss briefly a few of these factors which are considered the most important to our industry. The first four or five mentioned can be controlled to some extent directly by the industry. Price is a key, but not the principal competitive factor in international construction. We can control this by improved productivity and lower labor costs for example, by using third world country labor on labor intensive construction projects. Of course, we are at a price disadvantage when we are unable to match the mixed credit finance packages and soft credit offers of our competition. On the quality of our product, experience and technology and management capabilities, U.S. firms overall continue to enjoy a competitive advantage. Many foreign firms have the design and engineering technology, but lack the ability or experience to organize, implement and complete large and complex industrial projects. The international reputations of our AEC firms remain high, and the political role and strength of the United States continue to offer advantages.

With regard to exhange rates and U.S. government disincentives, these are in the hands of the Congress and the Administration, and we hope some progress can be made in easing the conditions. A reduction in the federal deficit should improve the current strong dollar relationship with other currencies and thereby increase the competitiveness of the U.S. manufacturing and services industries. However, we would like to see more progress in removing U.S. government disincentives.

I would add here that the heavy debt burdens of the debtor countries have been eased considerably in recent years by the financial support from the multilateral development banks — The World Bank, the Inter-American Development Bank and others. They deserve increased support from the U.S. government which is the key to additional support from other developed countries. The potential benefit to the U.S. and world economy of this industrial and infrastructure development is immeasurable.

A special set of factors affecting the competitiveness of U.S. firms seeking international AEC work involves U.S. government regulations for which there are generally no counterparts for our European and Japanese competitors. For example, many countries impose a tax on services used in their country even if those services were performed outside the host country. U.S. tax law considers such services U.S. sourced and, accordingly, impose a tax, and we are not able to offset this foreign income tax against our U.S. income tax. Most other countries make allowance for this particular type of foreign taxation placing U.S. firms at a significant disadvantage on many projects.

Another disincentive is the U.S. taxation of foreign earned income of U.S. citizens working overseas. These taxes were eased in 1981 by establishing a large exemption, but the new rules required that employee benefits in kind, such as housing and dependents' educational needs be counted as income, thereby reducing the benefit of the exemption. Accordingly, U.S. firms are required to pay higher wages and benefits for U.S. managerial and technical personnel than if foreign-earned income were fully tax exempt as is the practice of our major foreign competitors. U.S. tax policies thus remain a competitive problem restricting the use of U.S. personnel on overseas project.

Two other controversial disincentives to U.S. participation on international construction projects are the Foreign Corrupt Practices Act and the Anti-Boycott provisions of the Export Administration Regulations. U.S. AEC firms do not disagree with the intent of U.S. laws on corrupt practices and boycotts, however, we take the position that it should be possible to preserve the intent of these laws while removing the ambiguous and unnecessarily restrictive provisions.

Perhaps the most important disincentive or disadvantage to the AEC export industry is the lack of competitive export finance from Eximbank. Our foreign competitors often subsidize project financing for their design and construction work, provide mixed credits and supply more adequate and timely financing. Even as we speak, Mr. Chairman, the House-Senate Budget Conference is meeting to consider, among other items, the elimination of the Eximbank direct credit authority. Should this program be terminated, we feel our industry as well as U.S. manufacturers will be severely handicapped in their export efforts.

Because of these competitive disadvantages, a variety of business practices have been developed by international AEC firms. For example, U.S. firms over the years have established subsidiaries abroad or arranged joint ventures with foreign firms to obtain financing assistance to meet the finance requirements of construction offers invited by third country clients. In this way, more competitive finance can be obtained by the subsidiary in the host country than is available in the USA. As materials and equipment supply is linked to the financing source, the trade benefits accrue to the host country of the subsidiary rather than to the U.S. economy.

Joint ventures are now a common practice in the international AEC market, principally to bring together competitive strengths; these are usually arranged between a U.S. company and a major supplier in a foreign country. As an example, my company with technical and management expertise in designing and building fertilizer plants will team-up with a European or Japanese equipment supplier and constructor to bid on a project in order to provide the most competitive finance and construction labor costs.

I would like now to conclude with a summary of our industry views on what the future holds for our competitiveness on AEC international major projects. In this respect, I acknowledge to this Committee the contribution made by the U. S. Department of

Commerce in the July 1984 report entitled A Competitive Assessment of the U.S. International Construction Industry. We understand this report is to be issued again in July of this year and, furthermore, will include the results of the IECIC Price Waterhouse study which we discussed earlier.

The future demand for international services, and the consequent impact on the U.S. economy will depend largely on the economic strength of world and national economies, on national construction needs, and the capabilities of developing countries to carry out projects on their own. Until the worldwide recession eases, and debt servicing and high inflation continue to affect the third world, we do not forecast an improvement in major international construction projects in the next two or three years. Moderate growth may be expected through the late 1980s and through the 1990s, and it should occur in all geographic regions. This projection, of course, assumes no major economic collapse, major acts of war and moderate economic growth worldwide.

Developing countries will continue to increase their capability to undertake construction projects which will shrink the volume of business available to U.S. firms. On the other hand, large and technologically sophisticated projects should continue to be available to U.S. firms. However, it is clear that the levels of competition in all market segments will be intensive and the competitive environment for U.S. firms will be difficult.

The future U.S. AEC international industry competitiveness, and our ability to continue our strong contribution to the U.S. economy, we believe, will depend on the following:

- Sustained technical and project managerial leadership on major non-labor intensive projects as oil refineries, petrochemical plants and other industrial process facilities.
- Competitive financing assistance through Eximbank or other financing institutions as appropriate.
- Easing or removal of the several government disincentives to successful U.S. participation in the international AEC market; and
- Continuance of the highly favorable reputations of major U.S. firms for reliability, performance and effective management of large and complex projects.

APPENDIX A

THE CONTRIBUTION OF ARCHITECTURAL, ENGINEERING AND CONSTRUCTION EXPORTS TO THE U.S. ECONOMY

I. EXECUTIVE SUMMARY

> "This study demonstrates that, from the standpoint of the U.S. economy, the AEC export industry is an $11 billion industry which employs 261,000 U.S. personnel and generates over $1 billion in federal corporate and personal income taxes."

The U.S. architectural, engineering and construction (AEC) services industry is composed of more than 25,000 firms engaged in the planning, design and construction of utilities, industrial facilities, heavy projects, highways, buildings, and structures. Of the firms in this industry, approximately 400 directly engage in international AEC projects. It is this subset of the AEC industry that is the focus of this study.

This report profiles the AEC export industry, the size and nature of its exports in 1983 and 1982, and the impact of these exports on the U.S. domestic economy. The results presented in this report are based upon a survey of a representative sample of AEC firms. The survey was conducted by Price Waterhouse on behalf of the AEC industry from October to December 1984. The participants in this survey are listed on Exhibit IV, and a glossary of the terms used in reporting the survey results is included as Appendix A. This study was financed by the private donations of the companies shown in Exhibit V.

The results of this study show that in 1983:

- The U.S. AEC industry had export revenues of approximately $19.6 billion of which $4.8 billion represents direct U.S. revenues.
- An additional $6.1 billion of domestic revenues were generated as a result of AEC exports.

- For every $1 billion of direct revenues produced by AEC exports there is an additional $1.27 billion of indirect revenues from associated sales of goods and services, employment, etc.
- Total U.S. employment resulting from AEC exports was 261,000.
- Every $1 billion in total U.S. revenues generated by AEC exports results in approximately 24,000 jobs.
- Total U.S. wages resulting from AEC exports were $6.3 billion.
- Total federal corporate and personal income taxes resulting from AEC exports were $1.13 billion.
- AEC exports supported $1.4 billion in contracts to U.S. sub-contractors and the purchase of $1.9 billion in U.S. materials.

A. Profile of the AEC Export Industry

The AEC firms who participate in foreign projects are generally privately held corporations. Some of the many construction firms who actively participate in foreign projects include Bechtel, Blount, Fluor, Guy F. Atkinson, J. A. Jones, Lummus Crest, M. W. Kellogg, Morrison-Knudsen, Parsons, and Perini Corporation. Black & Veatch, CH2M Hill, CRS Sirrine, Emery Roth & Sons, P.C., Gilbert Commonwealth, IECO, I. M. Pei & Partners, The Louis Berger Group, Metcalf & Eddy, Skidmore, Owings & Merrill and TAMS are just a few of the many architectural and engineering firms who frequently export their services.

Twenty-four percent of all firms who export AEC services participate in joint ventures. This participation in joint ventures is a result of the complex nature of AEC projects, the need to increase bonding capacity or enhance financing capability, and the frequent practice of foreign governments to require local participation in AEC projects.

Foreign AEC projects range from the planning, design and construction of a Saudi Arabian city to an environmental impact study for a sewage plant. Illustrative AEC foreign projects for 1983 and 1982 include:

- Planning and designing a railway system in British Columbia, Canada;
- Planning and designing the rapid transit systems in Seoul, Korea and Vancouver, Canada;
- Designing earthen dams in the Phillipines, Nigeria, Chile, New Guinea and Argentina;
- Designing and constructing water distribution systems and water treatment plants and pumping stations in the Middle East;
- Designing and building the King Khalid Airport in Saudi Arabia;
- Designing and building a nuclear power plant near Seoul, South Korea;
- Installing a telecommunications system in Nigeria; and
- Constructing a pre-cast steel plant in Macao.

The U.S. materials purchased to support these foreign projects include building materials such as steel and roofing material, spare parts, pumping and sewage equipment and technical electronic equipment.

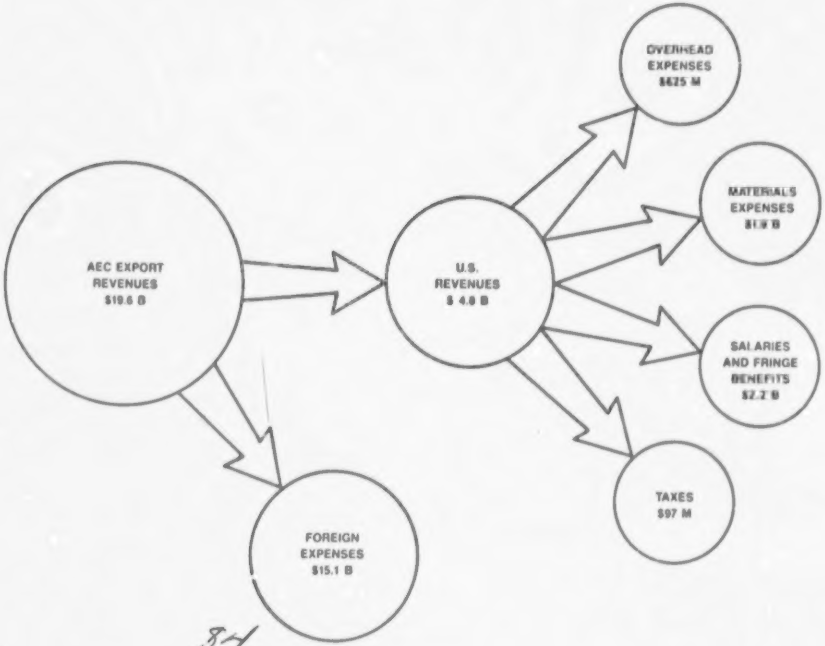
B. Direct Impacts of AEC Exports on the U.S. Economy

The AEC industry had export revenues in 1983 of approximately $19.6 billion. Of these revenues, $4.8 billion represent U.S. revenues, or total foreign revenues less foreign expenses. AEC 1983 export revenues directly generated 45,000 jobs for U.S. personnel resulting in $2.2 billion in wages and $267 million in federal personal income taxes paid. Further, the 1983 AEC exports generated $97 million in federal corporate income taxes.

EXHIBIT I

THE CONTRIBUTION OF AEC EXPORTS TO THE U.S. ECONOMY

DIRECT ECONOMIC IMPACTS OF 1983 SERVICE EXPORTS


OVERHEAD EXPENSES $625 M
MATERIALS EXPENSES $1.9 B
AEC EXPORT REVENUES $19.6 B
U.S. REVENUES $ 4.8 B
SALARIES AND FRINGE BENEFITS $2.2 B
TAXES $97 M
FOREIGN EXPENSES $15.1 B

AEC exports in 1983 supported $1.4 billion in contracts to U.S. sub-contractors and incurred $625 million in U.S. support and overhead expenses. In addition, the AEC firms purchased $1.9 billion in U.S. materials to supply their foreign projects.

Total 1983 export revenues were more than $2 billion lower than in 1982. In 1983 U.S. revenues decreased by $800 million from those in the previous year. The most significant reduction in U.S. goods and services supplied for foreign projects in 1983 took place in the materials sector which declined by $900 million from the 1982 level.

C. Indirect Impact of AEC Exports on the U.S. Economy

The effect on the U.S. economy of AEC industry foreign projects, however, is not measured only by the direct revenues they generate. The U.S. revenues from exports cause successive rounds of expenditure as AEC firms pay their U.S. employees, sub-contractors and suppliers. The U.S. employees in turn purchase consumer goods and pay taxes. The U.S. suppliers and sub-contractors employ other U.S. personnel and use their AEC export income to purchase supplies, materials, and capital equipment. Estimating the magnitude of these ripples is known as economic multiplier analysis. Its results demonstrate that the impact of AEC service exports may be more widespread and far-reaching than originally indicated.

The bases for determining the appropriate multiplier to be applied are U.S. Department of Commerce statistics which estimate the production required by each of 537 business sectors to support $1.00 of direct revenue. The multiplier values for construction and architecture and engineering revenues are 1.4 and 0.6, respectively. Therefore, $1.00 of direct revenue in construction generates $1.40 of indirect revenue in other sectors while $1.00 of architecture and engineering services generates $.60 of indirect revenues.

EXHIBIT II

THE CONTRIBUTION OF AEC EXPORTS TO THE U.S. ECONOMY

AGGREGATE IMPACTS OF AEC SERVICE EXPORTS

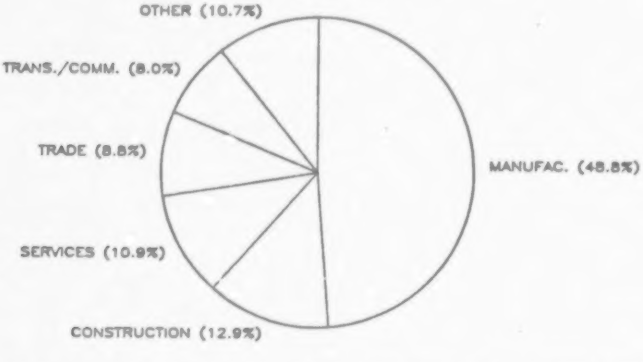
	1983	1982
U.S. Revenues Resulting from AEC Exports		
Direct	$ 4,774,966,000	$ 5,605,969,000
Indirect	6,126,410,000	7,292,358,000
Total	$10,901,376,000	$12,898,327,000
U.S. Employment Resulting from AEC Exports		
Direct	45,000	52,000
Indirect	216,000	252,000
Total	261,000	304,000
U.S. Employment Income Resulting from AEC Exports		
Direct	$2,159,195,000	$2,151,058,000
Indirect	4,157,173,000	4,705,666,000
Total	$6,316,368,000	$6,856,724,000
Federal Corporate Income Taxes Resulting from AEC Exports		
Direct	$ 97,260,000	$101,160,000
Indirect	102,102,000	121,346,000
Total	$199,362,000	$222,506,000
Federal Personal Income Taxes Resulting from AEC Exports		
Direct	$267,153,000	$ 267,992,000
Indirect	665,148,000	752,907,000
Total	$932,301,000	$1,020,899,000

Economic multiplier analysis of 1983 AEC exports demonstrates that an additional $6.1 billion in U.S. revenues were generated as a result of foreign AEC projects. Multiplier analysis can also be applied to derive indirect U.S. employment, wage income, federal corporate income taxes, and federal personal income taxes. As illustrated in Exhibit II, the results show that in 1983 exports of AEC services indirectly generated:

- 216,000 jobs for U.S. personnel;
- $4.2 billion in U.S. wage income;
- $102 million in federal corporate income taxes; and
- $665 million in federal personal income taxes.

The indirect effects of AEC service exports have their major impact in the manufacturing industry where they generated an additional $3 billion in revenues in 1983.

Exhibit III - Indirect Revenue Impact of AEC Exports by Major Industries



This result is not surprising, given that the AEC industry spends 10% of its export income on U.S. supplied materials and that the nature of this industry requires that these materials be manufactured goods such as building materials (e.g., steel), testing equipment, construction equipment and spare parts.

D. Summary

This report represents the first comprehensive study of the economic impact on the United States of the AEC export industry. The study is based on an industry survey which was unusual due to its extremely high response rate. The survey received responses from the construction firms that generate 76% of known foreign construction revenues and the architectural and engineering (A&E) firms that generate 62% of known A&E export revenues. This high rate of response significantly enhances the credibility of the study's results.

This study demonstrates that the benefit of AEC exports to the U.S. economy far exceed the initial export revenues returned to the United States. In order to measure the full impact of AEC U.S. revenues, it is necessary to include their indirect effects as well as their direct benefits. This study demonstrates that, from the standpoint of the U.S. economy, the AEC export industry is an $11 billion industry which employs 261,000 U.S. personnel and generates over $1 billion in federal corporate and personal income taxes.

The remainder of this report sets forth the background and approach to this study, the details of the study's findings and the methodology used to conduct the industry survey and design the questionnaire.

Representative OBEY. Thank you both very much. I think that information is very much what we have been looking for. I have a number of specific questions I would like to ask each of you about your operation. I just have one observation on the Eximbank, which I'd like to make first, and then ask you more general questions. Then, of course, I'll get back to the specifics.

On Exim, I simply want to caution you, don't pay too much attention to the number that is allegedly being set aside for Exim in the Budget Conference. The reason I say that is when I wear my other hat, I'm also chairman of the Subcommittee on Foreign Operations of the Appropriations Committee, which has jurisdiction over appropriation for Exim on the House side. And the fact is that the President, as he said, has eliminated all direct credits. He's presented us with a budget which is $3.2 billion or so below last year's level.

He has presented an overall budget of foreign assistance and that's where you'll find Exim, in that bill, which is many billions lower than last year and largely is lower because of that reduction.

The political realities of this place are such that there's not a chance of a snowball in you-know-where that we are going to have a foreign aid bill which is one penny higher than the President's. In fact, I expect it to be significantly lower.

Under those circumstances, I think the Budget Committee numbers for Exim will be very largely misleading because they are based on the assumption that the overall bill for foreign assistance will be a billion dollars higher than the administration's. That's an Alice-in-Wonderland assumption as far as I'm concerned. That means that they are playing with something that isn't real money.

I have met with Exim people two or three times. And, as a matter of fact, will be meeting with some of them again later today, and I will be telling them that unless they can get the administration to change their mind there's very little room, given the realities around here, for Exim financing, although I certainly share your assessment that the administration's quaint new way of going about it is going to be ineffective at best.

Having said that, let me ask both of you a broader question. Mr. Felix Rohatyn yesterday—I'm sure you're both familiar with him—a very respected figure in the entire area of international finance as well as the world of finance in general—said yesterday that the problem that he sees on the whole debt situation is that we have—he said—he didn't say this was a prediction, but he said you always have to take into account significant risks, and there is certainly a very significant risk.

He said we have a situation in which the entire world system right now is being built on a very huge amount of debt and a narrow base to support that debt in many regions of the world.

He said, for instance, that because of the fact that the United States is about the only country that's importing appreciably right now, that we are facing a situation in which our world economic conditions and our own economic policies as they are seen here domestically—and the implications for that internationally—are in effect creating more anti-American feeling and more opportunity for Marxism than Nicaragua is, that in terms of longtime threat to our national interests, that this problem is a far more serious problem to our own national interests than it is to a dictator in Nicaragua for the moment.

He also indicated that in his judgment right now what we had was a policy under which we are essentially squeezing out the opportunity for sufficient economic growth in Latin America in order to simply repay banks for past loans, and that means little opportunity for job growth in this country related to exports. For that region, it means little opportunity for them to either stabilize their political systems or to expand their imports in any way, and it was his judgment that we needed a series of actions, including debt restructure—or debt stretchout, I mean, further debt stretchout, reduction of our own interest rates through better control of the budget deficit situation, which he suggested included action on the revenue side as well as the spending side.

And one, that unless we were willing to do that, we were really slowly but surely acquiescing in the loss of a region like Latin America. I don't know if you feel that is close to accurate or not, but I would like both of your comments on it.

Mr. RICHARDS. I do not feel particularly well qualified to answer that question. I did see this morning that there is a dispute between the Chairman of the Federal Reserve and the Vice Chairman pretty much along the same lines, and there is the additional suggestion that some of this debt ought to be converted to equity. I have heard this suggestion before, and it may have some substance, although the Chairman of the Federal Reserve is not interested in that approach.

I don't really feel that I'm qualified. I think this is more a question that should be answered by an economist rather than a chemical engineer, and I would defer to an economist to respond.

I would though say that we, in order for our company to be involved in some of these debt-laden countries, have undertaken some innovative approaches to get business. One of them is the project I mentioned initially, where we are looking at equity participation ourselves and own and operate projects in the fertilizer industry. We can utilize natural gas that's now being flared to create energy in a number of forms.

So this is one approach we have tried. But I would prefer to confine my remarks to the industrial side.

Representative OBEY. Mr. Stevenson.

Mr. STEVENSON. I would pretty much think that is more of an economic question, Mr. Chairman.

Representative OBEY. OK. Let me just ask one more question before I ask Senator Proxmire to proceed.

Mr. Stevenson, the 1982 debt crisis pushed much of Latin America into a severe recession that we have all been talking about, which has been followed by the slow growth and limited availability of hard currency, and you indicated what that meant in terms of export sales of J.I. Case to Latin America. It's declined by 68 percent since 1980.

How does that correspond to the overall industry performance? What does the loss of export sales mean, in terms of jobs to your company and how has the debt crisis affected the workings of your Wisconsin-based operation? People also always asked, well, what does this mean to us? This has all happened in a faraway place, and it doesn't mean much, in terms of our own backyard. What is your response to that?

Mr. STEVENSON. Well, Mr. Chairman, Mr. Richards used the term 24,000 employees or $1 billion worth of export sales. He did say—and it's something I concur with—that probably in the manufacturing sector, the 24,000 jobs or $1 billion worth of exports is probably low. If you ask us to give you an educated guess, I think we would say closer to 30,000 jobs for each $1 billion worth of exports.

If you asked how this affects our company, I think I can answer that as to how it affects the industry. I think all I could say is probably a mirror image. We are not privy to their numbers, and I would prefer to speak only to J.I. Case.

Perhaps closer to home, especially for some of us from Wisconsin, our employment has dropped in Wisconsin from 4,900 people to approximately, 3800 people at this time.

Now having said that, I would add that it is not all a result of international or Latin American debt crises. We have a few domestic problems in our industry, but we feel in our company, again, back to the international situation, our best estimate would be that probably totally worldwide, the lack of export sales has cost us about 2,200 jobs. In Latin America, probably 450 to 500 jobs.

Representative OBEY. Mr. Richards, do you want to comment on anything Mr. Stevenson said?

Mr. RICHARDS. Well, I think we can say—I can speak for my own company—we have reduced the number of people in our various offices. We have had to close one office in New Jersey, and we are probably down at least 30 or 40 percent in the numbers of people in our organization since the late 1970's and early 1980's, so it's been a substantial drop in our numbers. And of course, the profits have declined as the volume of business has gone down.

So that it has had a very definite impact. I mentioned to you that the industry has suffered—the overall industry, architects, engineering, and construction—quite substantially, pretty much in the same ratio, probably in the range of 30 percent, at least.

Representative OBEY. Senator Proxmire.

Senator PROXMIRE. Thank you, Mr. Chairman.

I am delighted that both of you witnesses certainly are very helpful to us.

I notice, Mr. Stevenson, that in your prepared statement you say that your export sales, excluding shipments to Canada, which is part of the North American operations, have declined from a high in 1981 of $168 million to $86 million in 1984. That is a tremendous decrease.

Then you say, however, "The strength of the dollar has undoubtedly restricted U.S. exports. However, we have no doubt that for our company, Latin American debt problem has been the major deterrent."

Frankly, I am very surprised at that. I would think that the major problem for virtually all of our exports is the terrific beating of the dollar. After all, when you talk of this kind of situation, you have a price increase in effect for your customers in Latin American and elsewhere, don't you?

Mr. STEVENSON. No question, Senator.

Senator PROXMIRE. So it's cheaper for us to buy abroad and more expense for them to buy in this country. How did you arrive at your conclusion that that is a lesser factor than the debt situation?

Mr. STEVENSON. I think what we're saying there, Senator Proxmire—we concur completely with everything you just said on the strength of the dollar; however, we really do feel that were Latin American countries able to buy, they would buy, almost regardless of price, and we really think we have been hurt. I don't know if it's 60-40, or pick a number, but we feel, as well, the strength of the dollar is hurting us. The inability of these countries to service the debt they have is far less than, you know, incurring more debt and has been very detrimental to our business. I think this is what we were trying to say.

Senator PROXMIRE. Well, if that's the case, I think you would come down hard on the side of Paul Volcker. He's done a terrific job. There are a few people who seem to think his policy, tough as it is, is the right policy, and on the other hand, the Preston Martin would seem to have the position that placing a cap on interest rates on loans to financially ailing developing nations and converting some of their debt to U.S. banks into equity would certainly help the South Americans service their debt problems in the short run.

Why wouldn't that be the better approach than the tough textbook approach which Volcker is proposing, that is, to go through an austerity period which would mean they have less ability to buy from your company?

Mr. STEVENSON. What we're trying to say, Senator Proxmire is right now the lack of their ability to buy has had more of an effect on us than the dollar's strength. Their austerity to fix the thing long range, we cannot disagree with.

Senator PROXMIRE. Well now, the World Bank and the IMF have both insisted on austerity, have insisted on a tough program of cutting down on their imports, which would affect you, of course.

Mr. STEVENSON. No question.

Senator PROXMIRE. Getting inflation under control, and so forth, yet you say—you and Mr. Richards, I think, both of you seem to agree that the only game in town, as far as you're concerned, is the World Bank and the International Monetary Fund.

Mr. STEVENSON. I'll defer to Mr. Richards.

Senator PROXMIRE. Incidentally, I'd appreciate it, Mr. Richards, if you would talk to your junior Senator from Texas on that, and if you would talk to your Representative in Wisconsin and elsewhere to get off our back on IMF and on the World Bank. I think that you're absolutely right. It makes all the sense in the world. Here we have other companies putting in most of the capital, and we put up about 20 percent, and it's the most productive and economical kind of foreign aid operation.

Dave Obey has been one of the leading spokesmen in Congress on this, but we get clobbered by the Republicans who say we're helping the Commies, because once in a while, a relatively small loan is made to Yugoslavia or some other country that isn't on our side. But in your book, these are very useful organizations and very important to you.

Mr. STEVENSON. Yes, they are.

Senator **Proxmire**. Important to your industry and to jobs in Wisconsin; is that right?

Mr. **Stevenson**. I agree.

Mr. **Richards**. I would have to say the same as I said earlier. It is the only game in town. When we do not have competitive finance and can arrange for materials and equipment to be supplied from this country. They have funds available in developing countries. For example, we have done a number of ammonia projects using World Bank finance. We are also working with the IFC on some projects in the private sector where they are providing funds, so we are great supporters of additional funding for the World Bank. And when the U.S. increases their money, obviously, other countries do the same, so that we think it's a very worthwhile organization and it stimulates business in this country.

Of course, it also, under their procurement procedures opens up the market to all other countries—130 countries, potentially.

Senator **Proxmire**. I do have great admiration and respect for our Chairman, but he and I may disagree on the Eximbank. I really wonder why we can't make the reductions the administration has suggested. This is an organization which, by and large, has been known as the welfare state for Boeing. They get about 30 percent of this. Seven corporations get the great majority of it. I don't know how much J.I. Case gets. I doubt if you get a lot from the Eximbank, and I wonder why it would make any difference if, instead of direct loans, they simply subsidized the difference in interest rates. It would be a lot cheaper, which is what the administration has proposed. Why wouldn't that solve your problem?

Mr. **Richards**. Well, I have to argue with you, Senator Proxmire, that it's much cheaper. The IMATCH program, we estimate, is going to cost anywhere from $40 million to $60 million more per year to subsidize commercial banks. It is a budget item, I concede, which I don't think it should be, because the money gets paid back.

Senator **Proxmire**. You say it will be $40 to $60 million cheaper?

Mr. **Richards**. More expensive. The IMATCH program takes $40 to $60 million more, because the cost of borrowing from the private sector is going to be at least 1 or 2 points interest rate more than borrowing from the government.

Senator **Proxmire**. So if you subsidize the interest rate, you say that will be more or less?

Mr. **Richards**. I'm saying, if you subsidize it, it's more; it's going to cost the U.S. Government more money—$40 to $60 million more than if Eximbank borrows from the Federal Government.

Senator **Proxmire**. But it doesn't show up that way at all in the budget, because you don't make the loan, and the loan is like an expenditure, as far as the budget is concerned.

Mr. **Richards**. Our argument is that it shouldn't show up in the budget, or it shouldn't be in the budget to begin with, and because the money does get paid back, therefore the only real cost to the government is the difference between the borrowing and the lending rate.

Senator **Proxmire**. You're speaking for a trade association; is that right?

Mr. **Richards**. Yes; and also for my company.

Senator **Proxmire.** And your company. How much does your company use the Eximbank?

Mr. **Richards.** We now have an Export-Import Bank loan for a fertilizer complex in Nigeria, which has a value of about $230 million, and it is going smoothly. However, we have not used Eximbank as much in recent years. This loan was negotiated about 4 years ago.

Senator **Proxmire.** So you borrowed 4 years ago, $230 million, your company did?

Mr. **Richards.** Yes.

Senator **Proxmire.** Mr. Stevenson, how about J.I. Case?

Mr. **Stevenson.** We use the guarantee program.

Senator **Proxmire.** So you wouldn't be affected if they knock out the direct loan?

Mr. **Stevenson.** No.

Senator **Proxmire.** Why do you think the direct loan is important? You're a typical firm. It may not help Boeing if you knocked it out, and a few other mammoth aircraft sellers, but why would it affect anybody in Wisconsin adversely?

Mr. **Stevenson.** It would not affect us and we do use the guarantee program.

Senator **Proxmire.** Do you know any firm in Wisconsin that uses Exim in any significant way?

Mr. **Stevenson.** Can I turn that to Mr. Moe?

Senator **Proxmire.** Sure, go ahead.

Mr. **Moe.** Let me just add, historically, we have used the Exim programs, particularly the guarantee program. We used to deal with the discount loan program. Recently, we have used-----

Senator **Proxmire.** When you say "we", you mean J.I. Case?

Mr. **Moe.** J.I. Case Co. Recently, we have used the credit program—the medium term credit program—but fortunately we have internal financing that can compete or is much easier and flexible. The problem with using the Eximbank for ourselves is the debt problem itself, the inability to be able to obtain the Eximbank guarantee program for countries where we need to export, meaning that because of their debt burden, because of their ineligibility, because of their political risk, the burden of the debt Eximbank already has.

Senator **Proxmire.** Can either of you gentlemen give me any idea what difference it would make in terms of jobs for J.I. Case if you didn't have the direct loan program? Would it make any difference?

Mr. **Moe.** I'd like to say that if we did not have the ability to borrow and because of our company's strength itself, I think the medium term program would be very beneficial to us.

Senator **Proxmire.** But you do have the ability to borrow? As far as you're concerned, it wouldn't make any difference?

Mr. **Moe.** You're right.

Senator **Proxmire.** Thank you, Mr. Chairman. I have other questions.

Representative **Obey.** Congressman Scheuer.

Representative **Scheuer.** No questions.

Representative **Obey.** Let me say, following up that point, I guess the difference between Senator Proxmire and myself on this issue is that theoretically I agree with him. I used to oppose Eximbank vociferously because I do think it's a welfare program in a sense for companies in that any subsidies of any kind in our society are in fact a welfare assist for somebody, whether it's housing assistance or whether it's export assistance, whether it's medical assistance, you name it.

It all costs. But, the problem that I have is that our trading competitors are pushing us to the wall in terms of their use of these same subsidies, and I hate to see us—the administration says it's reluctant to follow unilateral disarmament on the military side.

I hate like blazes to see us following on the economic side. While the administration would dispute that interpretation, it is true that Mr. Draper, in testimony before the Senate Appropriations Committee on this subject, admitted that the administration's proposal would cost $60 million more—I believe the figure was 60 million—than the old direct financing or direct credit program would cost.

I also agree with the Senator that in terms of having to accept the cutbacks, there's no question Exim direct credit or no, is going to have to accept a major cutback. I would be amazed if the exporting community would be satisfied with what I intend to put in the bill as a mark.

But my only response to that is that if they can somehow figure out how to get the President to change his ceiling, then they can responsibly ask me to do something else; otherwise, they can't.

Let me ask some specific questions. Mr. Stevenson, in your testimony, you noted that you had a manufacturing facility in Brazil. Has the debt crisis affected the demand for goods of your Brazilian plant?

Mr. STEVENSON. Yes.

Representative OBEY. How?

Mr. STEVENSON. Mr. Chairman, to give you a number, about 50 percent. We were doing roughly $20 million worth of business prior to 1980—export business from Brazil to other Latin American countries—and that is now about $10 million.

Representative OBEY. And you attribute that directly to the debt crisis?

Mr. STEVENSON. Debt and inability of countries to purchase.

Representative OBEY. You note in your testimony that the commercial banks had considerably more leverage in rescheduling their debt. Has the ability of the banks to be first at the rescheduling table made it significantly more difficult to finance your trade with that region, or is that irrelevant?

Mr. STEVENSON. I think really the question there, Mr. Chairman, is the high debt and the bank's rescheduling. And, by the way, I hasten to add a lot of that bank debt perhaps was created by our industry, Mr. Richards' industry, and everyone else. A lot of it was trade-based in the first place.

But our problem is that the countries must be able to service their debt or we will continue to suffer. I think what we were trying to do in our testimony was point out the problems that private trade industry has. We certainly have no quarrel with commercial banks and really it is the country that determines the priorities of rescheduling, and they obviously are going to pay more attention to the huge debt the banks have than they do to our type of trading credit.

Representative **Obey**. Are any of you familiar with any proposals to bring private companies to finance trade into the rescheduling sectors of the commercial bank?

Do the various manufacturing companies work as a group when it comes to rescheduling issues?

Mr. **Stevenson**. Not really, Mr. Chairman. No. 1, there is some political, and believe it or not, while Macy's speaks to Gimbel's, we are competitors.

There was an attempt here in 1984 for a committee to be set up. Do you remember the name of that?

Mr. **Moe**. I don't recall the name, but it was a Washington ad hoc committee that was going to be formed, and I don't know if it ever got off the ground. I think particularly for Venezuela it tried to get trading creditors together as a body for leverage. But I can't recall the specific name. We tried to find that name and I cannot remember.

Mr. **Stevenson**. But to the best of our knowledge, it never got off the ground.

Representative **Scheuer**. You say you provide for leverage?

Mr. **Moe**. Well, as a group. We as a company did not. We don't have the leverage and as a group that was trying to bring suppliers together, if I recall, for Venezuela to influence the Venezuelan Government that other than the public sector debt there's a lot of trade debt outstanding. And, please, as a Government, address that issue also; don't leave us sitting in the lurch while the public sector debt is being rescheduled. And we're still waiting for that particular country.

Representative **Scheuer**. You're still waiting?

Mr. **Moe**. For the country debt to be rescheduled. There is an unofficial moratorium in debts in Venezuela. Imposed February or April 1983. We have several million dollars outstanding in Venezuela to date. J.I. Case Co. has several million dollars outstanding in Venezuela that have not been paid—interest or principal—because the country is waiting to reschedule officially that debt. They're first addressing the public sector debt, the private sector comes second.

Representative **Scheuer**. Can I ask a question?

Representative **Obey**. Sure.

Representative **Scheuer**. When you talk about rescheduling of a debt, do you have any sober second thoughts as to whether it was wise in the initial instance for you to place a debt on of the order of magnitude that was placed by the private sector? I would ask the same thing of banks.

We tend to look at the problem of debt rescheduling and the terrific burden it is causing Latin America as something they did that was unwise—and it probably was—but it seems to me that sometimes we forget to crank into the computer whatever complicity there might have been up here, both in the private sector—both in the individual firms and the banks, where it may be that they should have seen the early warning signals and they should have known that the order of magnitude of these debts and the order of magnitude of the debt service payments were simply too large for those countries to cope with.

And maybe we helped structure a situation for which there could be no return for them, which it had to be failure, which failure could be the only end product.

Do you have any sober second thoughts on the original placement of these debts? The judgmental factor?

Mr. Moe. Again, as we point out in our testimony, admittedly, we made some mistakes in some particular areas. But remember that we were providing regular terms of the trade. We had to provide those terms in order to compete in the industry. We had to provide——

Representative Scheuer. In order to compete with whom?

Mr. Moe. With our competitors. It was demanded by the buyer, whether it be our own dealer or the end user—the retail customer. We were providing what we call the terms of the trade, providing floor plan financing for the deal and a 1- to 3-year term of financing for the end user when that product was sold.

The debt problem for us came and for the dealer came suddenly. It came, you know, overnight. In Mexico, 1 night, we were shipping into Mexico, providing those terms.

Sure, we saw it coming, there was a gradual devaluation and we were very cautious in adding additional debt and we're doing it very cautiously, but at the same time we had debt that had gone back 1 and 2 and 3 years.

But, overnight, Mexico declared a moratorium on that debt and we were forced to wait. Our dealer was faced with the devaluation of the peso from 24/1 or 25/1, and today it's 200/1. He was reselling in dollars, his customers were buying in dollars and the customer was telling our dealer take the equipment back, forget it, I can't afford to pay. We, in turn, were refinancing and supporting that dealer. It just happened overnight.

Yes, we made—like I said, we made some mistakes in some cases, but at the same time we had to provide financing and were caught with it.

Representative Obey. Let me ask both of you, since you both referred to the importance of Exim, the importance of the international financial institutions.

I am a strong believer in the value of those international financial institutions and I am a strong believer that they play a very significant role in defending our own national interest abroad by their role in helping other economies to grow and restructure what those economies are doing or those government policies are doing.

But all of that money has to come from someplace. In your judgment, right now, as you know, it's all being financed by borrowing. Of the administration's foreign assistance request, 18 percent, if you would assign a percentage share to each of the 13 appropriation requests, every appropriation would have to be cut by 18 percent in order to equal its share of deficit.

We know that whatever we get on the spending side is going to be by way of—by way of savings it's going to be about $50 billion. That doesn't close the gap.

In your judgment, if you had to make a choice between pulling the plug significantly on the banks because we don't want to borrow the money to support the banks, or raising revenue in order to go along with spending reductions so that we are not financing those international institutions with borrowed money, which would you chose? Are they important enough to raise revenues to pay for or aren't they?

Mr. **Richards.** Well, I'd have to preface any comments I make on that question with the caveat that it's a personal observation rather than the views of our industry or my company. I personally feel that we have got to look at increased Federal revenues, and, I think, these institutions are sufficiently important for this economy as well as for the world economy, and I feel that if I had to make a choice that I'd go for some additional revenue.

Representative **Obey.** Mr. Stevenson.

Mr. **Stevenson.** I'll go back to our number.

What better way to raise revenue if, in fact, the numbers we gave you have any realism. Let's pick 24,000 or 30,000 jobs. I don't care which number you use.

Representative **Obey.** I'm not talking about that. My point is that if we finance any of these institutions to any degree, it's going to be on borrowed money. It's going to add to the deficit and it's going to help keep interest rates high.

My question is—I've got a choice. I can either fund those institutions on borrowed money which keeps interest rates high or I can say I ain't going to fund them, baby, until we get revenues to pay for them. Which would you do?

Mr. **Stevenson.** I guess I'd take the middle of the road. I think you have to have more revenue, Mr. Chairman.

Again, though, I go back. They need funding.

Representative **Obey.** OK.

Senator Proxmire.

Senator **Proxmire.** Let me follow up on that and broaden it a little bit.

You say, Mr. Stevenson, you're recommending what governments can do is develop monetary fiscal policies which will lower interest rates, ease the debt burden on debtors.

Now, the way you do that in the long run, of course, is to follow an anti-inflation policy, however tough and cruel and mean it may be. As you do that, because the expectations are that prices won't rise, interest rates tend to fall.

Now, if we are going to develop the kind of policy that I think you have in mind—perhaps I don't, correct me if I'm wrong—it will mean we've got to sharply cut the deficit, and to sharply cut the deficit we not only have to drastically cut spending but we also have to raise taxes. Are you willing to face that?

Mr. **Stevenson.** Yes.

Senator **Proxmire.** Mr. Richards.

Mr. **Richards.** I would be.

Senator **Proxmire.** Raise taxes as well as cut spending?

Mr. **Richards.** Yes.

Senator **Proxmire.** And you recognize that's essential if you're going to have a monetary and fiscal policy which will lower interest rates, ease the debt burden, and make our contributions to the international well-being?

Mr. **Richards.** Right.

Senator **Proxmire**. Then, Mr. Stevenson, you're last recommendation is develop trade policies which exporters can look to for consistency, a policy which, at least, is not a disincentive to our export efforts. Will you tell us what you mean by that?

Mr. **Stevenson**. I'm going to give that to Mr. Moe.

Senator **Proxmire**. OK.

Mr. Moe.

Mr. **Moe**. I think that exporters would like to look to the U.S. Government for a parallel support that we can consistently know where the Government is coming from in our export efforts.

In terms of disincentives, I think we're talking about some of the disincentives that you have heard before—the Foreign Corrupt Practices Act, the antiboycott legislation——

Senator **Proxmire**. The Foreign Corrupt Practices Act?

Mr. **Moe**. Yes, sir.

Senator **Proxmire**. That's my bill.

Mr. **Moe**. I know. [Laughter.]

Senator **Proxmire**. That's why you mentioned it?

Mr. **Moe**. Sure.

Senator **Proxmire**. The purpose of that is so that corporations wouldn't do what some of our corporations have been convicted of doing, bribing officials overseas. Are you in favor of that kind of bribery?

Mr. **Moe**. Obviously, not.

Senator **Proxmire**. Well, then why don't we need a Foreign Corrupt Practices Act?

Mr. **Moe**. Because I think we have to realize that it is occurring in countries overseas by other countries.

Senator **Proxmire**. If they do it, we should do it?

Mr **Moe**. No, I'm not saying that, but I think you have to make sure the policy, the law, the legislation, is not overly restrictive in terms of, you know, accounting restrictions.

Senator **Proxmire**. May I interrupt for a minute because the chairman——

Representative **Obey**. I just want to explain that these are the second bells on two votes which are occurring right now. So Congressman Scheuer and I are going to have to leave, so you're at the mercy of Senator Proxmire until we return. [Laughter.]

Senator **Proxmire** [presiding]. Go ahead, Mr. Moe.

Mr. **Moe**. Again, as I say, from an accounting standpoint internally. It's not overly restrictive in terms of the exporter. We know when we're acting in oversea markets exactly what we can and can't do.

Senator **Proxmire**. How can we stop this kind of bribery which is wrong? I'm sure you agree with me that sales ought to be on the basis of cost and competition and quality and not on the basis of how much you can pay some politician in another country in order to make a sale. And if we don't lead the way, how are we ever going to do this? You just have to accept the notion that this is a world in which bribery is going to have to be paid and we're going to have to pay our share?

Mr. **Moe**. No, we don't condone bribery. As a matter of fact, our company has a stricter internal policy than the U.S. laws.

Senator **Proxmire**. Well, then, what's wrong with our going ahead with legislation that prohibits it and does it in an effective way?

Mr. **Moe**. As long as it's realistic and not overly restrictive in terms, again, of accounting practices that we have to conform to.

Senator **Proxmire**. Well, accounting practices are the guts of it. If we didn't have the accounting detail it wouldn't be an effective and enforceable law. If we didn't require a paper trail so that we can determine and make the top executives of the corporations responsible for payments, you know perfectly well that those bribes would be paid. Is there any evidence at all—I haven't heard anybody explicitely show in any study or in any other way that this country has lost because of that legislation, because of the Foreign Corrupt Practices Act.

Mr. **Moe**. You're right. I think it's very difficult.

First of all, it's very difficult to pinpoint.

Senator **Proxmire**. It seems to me there's a good argument that you can make that it helps. If I were a foreign official, I'd be much more inclined to deal with the United States and I could say, look, I'm not engaged in bribery; the United States has a law that is very effective, that stops it.

So the United States is one country they can deal with knowing that they're not going, after what happened to one of the top officials in Japan and in Italy and in the Netherlands and elsewhere.

Mr. **Moe**. I agree with that.

Senator **Proxmire**. Mr. Richards, you say, and I quote,

> Two other controversial disincentives to U.S. participation in international commercial projects are the Foreign Corrupt Practices Act and the antiboycott revisions of the export administration regulations.
>
> U.S. AEC firms do not disagree with the intent of U.S. laws on corrupt practices and boycotts, however, we take the position that it should be possible to preserve the intent of these laws while removing the ambiguous and unnecessarily restrictive provisions.

I'd be willing to do all I can to remove ambiguous and unduly restrictive provisions if they did not also cut the enforcement effect out of the law.

Mr. **Stevenson**. I would add to what Mr. Moe said. I think our real criticism of the FCPA and the antiboycott restrictions are, one, that they are ambiguous and we—for example, we think there probably are too many restrictions in the accounting procedures. It makes a tremendous amount of work to create this paper trail you refer to. We don't think that's necessary and we think also that businessmen do not know precisely what they can do.

For example, there are some instances in doing business overseas where you entertain government officials and you might be in violation of the FCPA. So that, I think, is really amending it in order to remove some of the ambiguities.

Senator **Proxmire**. I'd be very grateful to you, Mr. Richards and Mr. Stevenson and Mr. Moe, if you would write the committee—write me and give me a detailed and specific language how you would correct this to eliminate any ambiguity and to make this, in your judgment, also effective.

Certainly we want legislation that will not in anyway hinder our export market which is so critical. At the same time, all of us agree that the scandals which really rocked this country and the international scene about 10 or 15 years ago, can do great damage to us and to our credibility as well as, of course, create an international atmosphere that makes sales abroad a fiasco because, as I say, if we rely on bribery and not on quality and price.

You also had other disincentives. Can you comment on those? In your final recommendation, Mr. Richards, you say, "Easing or removal of the several Government incentives to successful U.S. participation in the international AEC market," and the one I highlighted is the Corrupt Practices Act, but what else?

Mr. **Richards**. Well, the antiboycott provisions have been, we think, restrictive and, I think, there has been easing of that recently. There are countries that have eased this considerably. But there is an ambiguity there because there are regulations that are prescribed by two different agencies—the Commerce Department and the Treasury—and it doesn't affect our industry nearly as much as it does our suppliers.

Senator **Proxmire**. This is particularly with reference to the boycotts with respect to Israel by Arab countries?

Mr. **Richards**. Yes, that's primarily it.

Senator **Proxmire**. Have there been specific examples of loss of trade amounting to a significant amount of money because of the antiboycott provisions that we have?

Mr. **Richards**. I can think of some, years ago.

Senator **Proxmire**. In the last, say, 3 or 4 years?

Mr. **Richards**. I can think of one or two in Arab countries where they required us to state that we do not do business with Israel.

Senator **Proxmire**. What are they? Can you tell us what they are?

Mr. **Richards**. I recall one that involved a project in Kuwait where a company was required to state they did not do business with Israel and if they did not agree to this, they couldn't do the business. They had to decline to bid. And I know this has happened in other instances. But I don't think that's a principal problem; it has been a problem but it is easier now. I think our main problem is having to follow a number of regulations that are difficult to interpret.

Senator **Proxmire**. Do you do business with Japan? A significant amount?

Mr. **Richards**. No, we don't sell to Japan, but they are very good trading partners and joint venture partners on a number of projects.

Senator **Proxmire**. Would you buy from Japan, if—I should say, would you sell to Japan, if you had a different situation with respect to our currencies?

My question is, do you not sell to Japan because you can't get into their markets, because you're not price-competitive because of the difference in the value of the dollar and the value of the yen? What is the reason that you don't?

Mr. **Richards**. Well, I think you should ask that question more of the manufacturing industry than the engineering and construction industry. We have sold to Japan where we have a special technological advantage, for example. We have sold ammonia and urea plants to Japan in past years. That market is no longer open, because they have obtained the technology and they can now do this design engineering and construction themselves.

Senator **Proxmire**. The reason I am asking this question—and perhaps Mr. Stevenson can help us on this too—you are very refreshing witnesses, in that you haven't come in and cried and wept about the argument that the other countries are keeping us out of their markets. I haven't heard a word about that, but I want to hear something about it now, if there's anything to be said, because there is that complaint. This conviction on the part of many Members of Congress—I don't know to what extent it's true—that we are excluded from many markets—the Japanese markets, the common market, to a considerable extent for many products, and that we have to find some way of opening up those markets. One way is by retaliation on our part, and I'd like to get both of you gentlemen to give me your opinion on what we should do about that.

Mr. **Richards**. Well, one of the problems engineering contractors and architect-engineers have in foreign markets is that there is a trade barrier, in that they have certain restrictions that do not permit open engineering opportunities in both developed and developing countries. So there are certain trade barriers that have been set up.

We, as an engineering constructor, are not as affected by this, because we try to do most of our engineering in the U.S.A., in any case. And right at the moment, because of the very favorable Japanese situation on currency, and their competitiveness in their own manufacturing industry—we are using them on oversea projects. For example, a large project in Australia where we're building—a liquefied natural gas project and also a large LNG project that we have completed recently in Malaysia. We are using Japanese engineers, and we are using a large amount of Japanese equipment, simply because they are the most competitive, and they can offer very good finance terms.

So I would conclude that market access is not as important a factor to the engineering and construction industry as it is to manufacturing.

Senator **Proxmire**. Mr. Stevenson, you mentioned something about the methods used by Latin American countries to hamper your abilities to export into their markets. Can you give us a little more data on that and what your recommendations are as to what we can do about it?.

Mr. **Stevenson**. Again, I'm going to pass to Mr. Moe.

Senator **Proxmire**. All right. Mr. Moe.

Mr. **Moe**. I think what we said is that in Latin America there are high tariffs in many countries. There are austerity measures that have been introduced, like in Argentina, where an importer has to put up 150 percent deposit, in order to open up a letter of credit to import—or to get the import license.

Senator **Proxmire**. You say "austerity measures." You say that's part of Alfonsin's program?

Mr. **Moe**. When I'm talking about austerity measures, I'm saying Latin America, in general. And I'm using that as a figure of speech in terms of methods the governments impose, in order to restrict imports. They emphasize the exporting industries and deemphasize imports into those countries. And in some countries, if there is local manufacturing, we are completely shut off from those particular countries.

Senator **Proxmire**. For instance, J.I. Case's tractors?

Mr. **Moe**. Right. And Mexico is an example. It is very difficult to get import licenses for some of our construction equipment, if not impossible.

Senator **Proxmire**. Is that protectionist?

Mr. **Moe**. Again, to emphasize their exports and to encourage their own industry.

Senator **Proxmire**. Do you have any recommendations what we can do to overcome that? Is that a violation of GATT, in your view?

Mr. **Moe**. I don't believe it is. They are, again, trying to develop their own infrastructure. What we have to do is to find a way to manufacture locally, if it is profitable for us.

Senator **Proxmire**. The fact is that Mexico is not a member of GATT, as I understand it, but it still could be a violation of the principles.

Mr. **Moe**. I'm not qualified to be able to say whether or not at this point.

Senator **Proxmire**. Do you think it is practical for us to devote an effort to opening up the market, or do you think that because of the necessity for their protecting their industries that it is unlikely that we can get much in the way of results that way?

Mr. **Moe**. I think the bottom line is that what we like to see is reciprocity. In other words, treat ourselves as well as we treat them in imports into our country.

Senator **Proxmire**. We would like to see that, but the question is, how do we get it?

Mr. **Moe**. I think that is where the Government can play a key role. As I said before, arm and arm with business in trying to provide that support rather than verbally talking about it, actually saying we need your support, or we are going to support the U.S. industry when you are talking in your negotiations with foreign governments. You have to be firm.

Senator **Proxmire**. Well, here you have a situation where, as I understand it, Mexico has a favorable balance of trade now with the United States.

Mr. **Moe**. It has dropped considerably in the last year again.

Senator **Proxmire**. It's dropped, but it's still favorable.

Mr. **Moe**. Right.

Senator **Proxmire**. So it seems to me we're in a stronger bargaining position. In other words, if trade should cease between the two countries, they would lose more than we would, plus the fact our economy is so much bigger and stronger, and it would have a far more devastating effect on them than on us. It seems to me we have a bargaining position, so why not use it?

Mr. **Moe**. I agree that we should use it.

Senator **Proxmire**. You agree with that, Mr. Richards?

Mr. **Richards**. Yes; I think so.

Senator **Proxmire**. How would you do it?

Mr. **Richards**. Well, it's very difficult. I wanted to mention along those lines a very interesting bill that has just been introduced, sponsored by two Members of the House, Representative Duncan and Representative Guarini, and in the Senate by Senator Heinz. It has been developed by a coalition in Washington called LICIT, the Labor Industry Coalition for International Trade. It has a number of important provisions, and has gone through about 29 revisions over the last 2 or 3 years. I think it has a number of remedies for the trade problems we are discussing.

Senator PROXMIRE. How does that proposal by Senator Heinz, LICIT, as you call it, prevent us from slipping into a protectionist situation which would be inflationary and which would damage our opportunities to have healthy trade in the long run?

Mr. RICHARDS. I'm not sure that I'm capable of answering that one. I am involved with LICIT, but I'm not really an expert on trade.

I would like to respond to your question by calling on others in LICIT who are experts on this trade bill.

Senator PROXMIRE. I'd appreciate that very much, if you would let us have your response in the record.

Mr. RICHARDS. I would like to, Senator Proxmire, because I think it is a very important bill, and I think it does have remedies for a number of these trade problems, but I don't think it causes the problems that you're suggesting.

On the subject of joint ventures that we spoke about earlier, Mr. Hoffman of Price Waterhouse has mentioned he has some statistics in our study—the IECIC study—that I think may clarify it.

Senator PROXMIRE. Good. We have neglected Mr. Hoffman, unfortunately.

Mr. Hoffman, you are the scholar. You have done the work here. And we'd like very much to hear from you. Go ahead.

Mr. HOFFMAN. Thank you very much, Senator Proxmire. I would just like to make a point on the issue of how much work U.S. firms are prevented from doing overseas due to various trade barriers. There is some evidence in the study of the number of joint ventures that are formed on larger projects. We heard from many of our correspondents that these joint ventures are specifically formed with local firms to get around the limitations on foreign content in local engineering projects, although many of the joint ventures, I'm sure, are formed for competitive purposes—to keep our prices as low as possible. One statistic that does come out of the study is that of the total export revenues of the AEC industry in 1983 of close to $20 billion, $15 billion of that, fully three-quarters, was left in foreign countries. Less than $5 billion came to the United States as U.S. revenues.

So when we talk about the impact of that $5 billion coming to the United States, the number of jobs it creates and the amount of income taxes paid to the Federal Government as a result, we're only talking about one-quarter or the total export earnings of the AEC industry. Three-quarters of that work is done overseas.

Senator PROXMIRE. So everybody gains from this, but our trading partners gain even more than we did, but we gain too?

Mr. HOFFMAN. That's right. We certainly gain in the number of jobs and the amount of taxes paid, but our trading partners are gaining to a great extent. Local countries are gaining by increasing their skills and their competitive stance.

Senator **Proxmire**. All four of you gentlemen got into the performance contract use and I'd like your comments on the use of so-called performance contracts in which certain Government-set restrictions on both the nature of production and the marketing of products.

Mr. Stevenson, you made an excellent point that while we often hear about the problems facing banks because of the Latin American debt crisis, we rarely hear mention of problems of private debt owed to suppliers such as yourself.

Could you elaborate a little bit on your comments concerning J.I. Case's experience in that regard as a supplier?

Mr. **Stevenson**. Well, I think, Senator Proxmire, what we are saying there, Mr. Moe had mentioned Venezuela and we would like to see some type of effort where the governments of countries with whom we do business recognize the fact that as well as the public and bank debt that the trade suppliers have made a real contribution to them. Now——

Senator **Proxmire**. Well, that's a very good point and it kind of falls through the cracks. In other words, what you're saying is that the governments recognize how vital it is that their companies have an ability to borrow from American banks—Citibank, or whatever. They don't have the same regard for the credit which might be much bigger, or at least is comparable from——

Mr. **Stevenson**. I think it would be smaller.

Senator **Proxmire**. But, at any rate, it is substantial from suppliers such as J.I. Case, and others.

Mr. **Stevenson**. Yes. It's significant. And we would like to point that out.

Senator **Proxmire**. Of course, the difficulty is that I suppose it's easier for a bank to kind of step away from a situation. You pointed out that once you give up that market, it's lost. Or likely to be lost forever.

Mr. **Stevenson**. At least a number of years.

Senator **Proxmire**. And you devoted a long, long time to building.

Mr. **Stevenson**. And, again, back to why do you do it? What does it cost you if you don't do it? If you walk away from that, you know, we talk about Brazil and it's a country of tomorrow, but if you ever walk away from that thing, it will be a long time before you're back in there.

Senator **Proxmire**. Do either of you gentlemen or your firms do much business with Argentina?

Mr. **Richards**. Yes. We're not doing very much now. As I said earlier, we feel that we have statistics that are very rough and approximate indicating that our business since the 1970's has decreased on the order of 75 to 80 percent in Argentina. We have built many of the refineries and petrochemical plants in Argentina. They do have the raw materials, for example, to produce fertilizers. They simply do not have hard currency to build the plants.

Senator **Proxmire**. Well, in view of the terrifically restrictive Alfonsin program, as announced the other day, which is the most restrictive that I have heard anywhere, in which they are trying to revalue their currency 1,000 to 1, slapping on wage-price controls, requiring forced savings and a big increase in taxes, including customs, so that it's harder to sell into Argentina, the expectation is that the economy is going to go into a nosedive and stay there for a while as they recover.

It's probably the right medicine, but it's very, very strong medicine. It seems to me that that would be the kind of a situation that would be very hard to sell in.

Mr. **Richards**. I think it is. One of the areas I did mention was the possibility of getting together a group of investors to build a plant—outside investors to build a fertilizer plant that can utilize the natural gas in Argentina and produce ammonia there which can be exported for hard currency and help them out on their debt problems.

Senator **Proxmire**. Mr. Chairman, I'm glad to see you back. I've been conducting kind of a filibuster here, but it's been very enlightening.

Representative **Obey**. You?

Senator **Proxmire**. Imagine that. But these are excellent witnesses and I certainly learned a lot and I want to thank you very much.

Representative **Obey** [presiding]. Well, thank you. I just want to apologize for the disjointed nature of the hearing, given the rollcalls that we have had. It's another example of the way this place works. A terribly crucial rollcall when I left the House floor. The amendment was ahead 108 to 2. But we had to have a rollcall on it anyway.

I don't know what you have been covering with Senator Proxmire. I have a number of questions, but in light of the time, I'll forego most of them. Let me just ask two.

You mentioned you are engaged in a number of innovative efforts to try to keep exports going. Let me ask you what would seem to be an offbeat question.

Do people pushing your products speak the language of the countries you are dealing with?

Mr. **Richards**. Yes.

Mr. **Stevenson**. Yes.

Mr. **Richards**. We have representatives in Latin America that are Spanish speaking.

Representative **Obey**. Let me ask you, Mr. Richards, obviously, in part when you talk about what you see in terms of your export opportunities, you are also taking into account what America's economic policy is going to be and what our economic conditions are going to be here at home.

What expectations about the U.S. economy underlie the view that you expressed in your testimony that you did not expect a major pickup of business in the next year or two?

Mr. **Richards**. Well, I was referring to the AEC—the architects and engineering construction business—more than the overall economy. We do not see that in our particular line of business in heavy industry that there's going to be a great deal of expansion.

For example, the oil refining and petrochemical and fertilizer industries, the steel industries, are not operating at full capacity now and we do not see that as improving much over the next few years.

The business that we look for is going to be pretty much modernization, expansion in certain parts of the refineries and plants. I don't think that I can comment as well on the overall U.S. economy, and I'd rather leave that to the economists.

Representative **Obey**. Well, you may feel the same way about this next question but I want to ask it anyway.

Mr. Stevenson, some analysts have noticed that the pattern of rescheduling—and I touched on this before—has been designed to maintain the earnings of the lenders, including the money center banks and that as a result, Latin American countries have been less able to import construction equipment, farm implements, and other goods, that in turn, U.S. exports and jobs in the effective industries have been lost.

Do you think your own experience tends to support that view? And while I know you indicated that you would prefer to leave the question to the economists, in light of the argument going on today and in the newspapers, for instance, I noticed that David Mulford of Treasury—Assistant Secretary for International Affairs, said that while it would be comforting to believe Latin America is poised for resumption of growth and prosperity, there's a real danger we are seeing the calm before the storm.

With the region arguably at the brink of new financial problems. And when you see other stories, such as the one that appeared in the Wall Street Journal on the 26th of April, which said that despite the respite from the cliffhanger days of 1982 and 1983, many economists argue and some bankers privately agree that major problems could abruptly resurface.

In light of that, you must have some feelings, and you may have touched on this while I was gone. You must have some feelings about the advisability of stretching out those repayment schedules in order to make available some greater opportunity to those countries to use a portion of their earnings to finance trade and develop it, rather than using them so heavily just for existing debt repayment.

Do you want to make any comments on that?

Mr. **Stevenson**. Well, I think only this. No. 1, I don't think we can comment on bank procedures, nor do we care to. But we do feel that until these countries can reschedule some debt, not arguing at all that long term obviously is to get this thing happening, but it's a little like, you know, putting the brakes on when you're going ahead, rather than throwing the thing into reverse.

I guess our feeling is we will continue to suffer unless there is some kind of a rescheduling.

Mr. **Richards**. I think there is a case definitely for rescheduling and I would also add that—I think we've got to add to the funding of the development banks in order to get these developing countries, who are debt-laden, over these crises, so that they can at the same time as they're struggling to pay off these debts, they can expand their economy in order to do so. So I would very strongly support the funding of the development banks.

And I might add one other point that has always been a difficult problem with me and that is that AID has not always been as supportive of industry in their activities in the developing world. There is a philosophy of being much more involved in the infrastructure and they don't seem to think that the creation of jobs in the industrial sector is as important.

Now, we think they are changing. For example, much of the AID work in Egypt is going into industrial projects which do benefit the economy locally as well as the economy in the United States. So I am happy to see that, but I think those are two areas where we can help developing countries that have large debts.

Representative OBEY. Well, there are three or four other questions I would like to put in the record and ask you to respond to. But let me just make one last observation on the international financial institutions.

I agree again that the problems are crucial. I regret it very much, seeing the administration cut back its negotiating—or the level of its negotiating position for the new slices. And, yet, I have to say I don't see any real prospect for increasing it much in the future through direct U.S. participation.

I am intrigued by the suggestion of Mr. Rohatyn and others that there ought to be some way, since Japan is the OPEC of the eighties, in terms of the money they have sloshing around. They're going to have, by the end of the century, anywhere from half a trillion dollars to $1 trillion in loose capital, and I am intrigued by the question of how you can get them to participate in an international financial effort to allow some opportunity for growth in Latin America, perhaps in return for a share of the economic proceeds on the other end.

But it seems to me that that is an area that needs to be explored heavily, given a limited financial ability at this point or political ability to deliver any greater levels of support for the international bank.

Congressman Scheuer, did you have a question or a comment?

Representative SCHEUER. Yes.

Mr. Richards, you were saying before that while we're helping or hoping that the Latin American countries are going to repay their debts and while we presume we will help them restructure their debts, we ought to help them expand their economies; is that right?

Mr. RICHARDS. Yes.

Representative SCHEUER. How would you advocate we help them expand their economies without falling into the same trap we fell in the last time we helped them expand their economies which was to place them in this impossible debt situation, albeit with their connivance.

Mr. RICHARDS. Well, it seems to be inconsistent, but I think that——

Representative SCHEUER. There may be other ways of helping them expand their economies.

Mr. RICHARDS. There are two ways. One, of course, is increased World Bank funding to help them out.

Representative SCHEUER. You mean direct grants?

Mr. RICHARDS. Direct grants.

Representative SCHEUER. Not loans.

Mr. RICHARDS. And the possibility of equity participation by outside foreign interests with hard currency; such as the United States and other major countries.

Representative SCHEUER. From the political point of view, I would have to say, I would have great reservations as to whether that would hold a great deal of promise.

Mr. Richards. The first part.

Representative Scheuer. No, the second part. The great colossus of the north coming down here. Look at how sensitive Canada is to the fact that Americans own practically everything in sight or a major share of their oil industry, their coal industry, their forest products industry, and they are a very civilized, sophisticated, and advanced, developed country. They harbor the most deep-seated, emotionally tinged anti-American hostility that they're only just beginning to get over with their new conservative Prime Minister.

The anti-Americanism has been so endemic in Latin America for so many years, I'm just wondering whether equity participation, which is a phase that rolls very glibly off all of our lips here as the way we've prospered over a century or more, but for the colossus of the north to go down there, grabbing equity shares in their profits, I think would be fairly politically explosive.

But, anyway, continue. How do we help them expand their economy?

Mr. Richards. Well, we're going to try equity participation in a methanol plant in Chile, and that project is in the formative period right now. We think it's going to be a success and certainly we'll utilize their natural gas resources to produce a product which they can sell for hard currency—we're going to give it a try.

Representative Scheuer. Will this be guaranteed by OPIC?

Mr. Richards. Yes; I believe so.

Representative Scheuer. Now, later on you comment that it would be a good idea if we could make them see the light on the role that industry played in their overall development program.

Is the industry that you're promoting down there high technology? Is it capital-intensive industry?

Mr. Richards. Yes, pretty much. Our industry designs and builds large plants in the processing industries there.

Representative Scheuer. That kind of industry according to the World Bank is capital intensive and job saving.

Mr. Richards. Yes.

Representative Scheuer. It's really not the kind of economic development that most Latin American countries need. What is scarce down there is capital. What is plentiful down there is labor. What they need is capital-saving, labor-intensive industry, to put their people to work, to put the one thing they have in abundance, to use domestic supplies to turn out a product for the domestic market as well as the international market, using above all domestic labor.

The problem causing the most instability in Latin America is the lack of jobs. And I know there are officials in the World Bank that feel they have to change the investment patterns in the developing world countries from capital intensive and labor saving to labor intensive and capital saving. I mean it's so transparently clear to professionals like you that what they have in abundance is labor and what they have in great scarcity is capital, and for us to give them something that saves labor by large investments in capital, just defies every rule of economic sense.

I might also say, from the political point of view, that the largest source of instability, chaos, revolution, call it what you will, is happening and will continue to happen in larger and larger degree from joblessness as the population growth outstrips their ability to provide employment for their people.

Let me just give you a brief example.

Are we running out of time? You want me to shut up, Dave?

Representative Obey. Go ahead.

Representative Scheuer. The World Bank tells us that by the end of this century the developing world will have to find approximately 800 million new jobs. Now, that is more than the entire employed population of advanced industrialized developed world. It's inconceivable that they could do a fraction of one-tenth of that. It costs about $10,000 a job to create a job in Mexico. It costs $1,000 to create a job in Egypt.

Let's take $1,000 in Egypt. It probably costs more than that in most of Latin America, but let's take the Egypt figure. They have to produce 4 million jobs by the end of the century just to keep the present pitiful level of unemployment and underemployment, about 50 percent. So you're talking about $4 billion. I don't know where we're going to find $4 billion to create new jobs in the next 15 years in Latin America; 4 million jobs a year.

Our own GNP, the American economy, is about five times that. About five times the Hispanic-American economy of all Hispanic America. We have never exceeded the production of about 3.2 million jobs. We did that 1 year during the roaring seventies, so to think that they're going to meet the need of 4 million jobs a year is preposterous. They're going to keep falling farther, and farther, and farther behind. So what they urgently need is labor-intensive, capital-saving, economic enterprises.

And it seems to me this is what the World Bank and the Inter-American Development Bank, and our own AID people, and the most creative minds in the industry should be concentrating on.

I would very much like it of you four highly trained professional, thoughtful people, would give us the benefit of your thinking on how we could add to employment in Latin America. They really don't need heavy industry. What they need is jobs, jobs, jobs, to prevent instability, chaos, disintegration of their society, vast hordes of people coming north to crash through our borders as is happening now; 60 percent of the people who crash through our border—the Mexican border into our country—are Mexicans, but 40 percent of them just transit Mexico from Central and South America because they're looking for one thing—jobs. And that's the result of a whole lot of things, but among others, to some extent it's a preoccupation with capital-intensive, laborsaving economic patterns, when what they need is exactly the contrary.

I beg everybody's forgiveness for this long question. There's no question mark at the end. Would anybody like to respond?

Mr. Hoffman. Representative Scheuer, I agree with you that what Latin America needs is jobs and what it has in abundance is labor. One other element it has in abundance is natural resources. Many of the projects that we're talking about, although they themselves are capital intensive and laborsaving, jobs open up in natural resources.

For example, take a pipeline or a rail line that allows you to open a coal mine in the interior. That does provide a large number of jobs even though the rail line itself is capital intensive. So I think it's a balancing that one looks for and also the indirect impact of a particular project that you're investigating.

Representative SCHEUER. You make an excellent point.

Representative OBEY. Let me just say in closing that I appreciate your coming.

One of the reasons that I have such a special concern about Latin America, or really there are two. One, I think is summarized by the way the Japanese have manhandled us in the semiconductor industry. You see the way they dealt with us. If you try to assess whether we're playing on a level playing field or not, you see what small portion of the Japanese market we get in that product line, and then you see how we do vis-a-vis the Japanese in an area where there's a more level playing field, such as Europe. And you see that we're going to have difficulty for a long time, despite the best efforts of any administration to sufficiently penetrate an Asian market.

If you add to that what some people see in this maze as certainly oversimplified as I'm describing it, and certainly it may not be the picture at all, but at least some people see a trend toward the following: They see Europe, because of their reluctance to invest, falling farther and farther behind in terms of their ability to compete.

If we had an even playing field in terms of the dollar value, they see eventually there trading clusters, with a lot of exceptions, but essentially three trading clusters.

They see Western Europe, and increasingly Eastern Europe, and the Soviet bloc using Africa as a raw material base. At one regional center they see the Japan-led Asian arena, then they see the United States/Canada/Latin America. And I keep repeating, with obvious exceptions, certainly not hermetically sealed trading areas, but with heavy emphasis in that direction.

If that is at all even closely resembling what the future could hold, then one must be concerned about what is going to happen in the next 10 years in developing the ability of Latin America to import as well as export, because of the effect that that has, not just on their economy, and on their society, and on their politics, but also on the political and economic effects that has here in the United States.

And when you see Morgan Stanley, for instance—Morgan Guarantee Trust, I'm sorry—saying that banks concerned for their capital limit their ability to extend substantial new loans to developing countries for some years to come. And when you see others suggesting that it won't be until the end of the decade before you see any significant reentry of those countries into real lending markets, it does have at least a potential for serious long-term consequences to the United States.

And I think you have helped us in at least a small way paint a piece of what that picture could be, and I thank you for coming. The committee will stand in recess.

[Whereupon, at 12:05 p.m., the committee recessed, to reconvene at 10 a.m., Monday, June 24, 1985.]

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THE IMPACT OF THE DEBT CRISIS ON THE U.S. ECONOMY

MONDAY, JUNE 24, 1985

Congress of the United States,
Joint Economic Committee,
Washington, DC.

The committee met, pursuant to recess, at 10 a.m., in room 2218, Rayburn House Office Building, Hon. David R. Obey (chairman of the committee) presiding.

Present: Representatives Obey and Hamilton.

Also present: Kent Hughes, Sandra Masur, and John Starrels, professional staff members.

OPENING STATEMENT OF REPRESENTATIVE OBEY, CHAIRMAN

Representative Obey. Good morning. Today is the third day in a series of JEC hearings on the impact of the Latin debt crisis on the U.S. economy. The first 2 days of hearings have helped flesh out some of the dimensions of the problem.

In terms of Latin trade, we've gone from a $7 billion surplus in 1981 to a $16 billion deficit in 1984, according to Professor Jerry Adams, who testified before us a week ago. The $23 billion swing in our regional trade balance cost the country, in his estimate, 800,000 jobs in 1984. Those jobs and export losses are not just economic abstractions. On Friday, we took testimony from J.I. Case, a major manufacturer of construction equipment and farm implements, and from Kellogg Rust, a leading overseas construction firm, which illustrated the impact of Latin debt problems on individual firms.

In addition, as we know, the debt crisis put considerable strain on the U.S. financial system. A week ago, John Petty, the chairman of the Marine Midland Bank, testified that in 1984, U.S. banks had almost $90 billion on loans outstanding to various Latin American countries. And according to figures contained in a recent report of the CRS, that for many banks, their Latin American exposure exceeds their total capitalization, and in the case of at least three major money center banks—Citicorp, Chase Manhattan, and Manufacturers Hanover—Latin loans are more than double the banks' capital.

The questions involved are not just economic in nature. I apologize for often referring to my subcommittee when I'm discussing issues like this, but in that subcommittee, we are reminded daily that countries like Brazil and Argentina are struggling to build democracies under enormous pressures of international debt, slow economic growth, and rising populations.

Mexico is under enormous pressure. Foreign policy issues have tended to obscure the serious debt problems of a number of Central American countries, including Nicaragua.

Beyond politics, the debt crisis also raises a series of ethical questions, which, in turn, have political implications. It appears that a significant amount of international debt accumulated by Argentina flows into private accounts overseas. The average working Argentinian may have difficulty understanding why he or she should be making major sacrifices for a sustained period of time to repay American banks for funds that have already found themselves back to Miami, or are on the way back to Miami.

And there are other questions involved. And, finally, the debt crisis, itself, as we know, is a product of the sharp and sudden shift in U.S. economic policy. In John Petty's words, the major worldwide recession in 1981 and a U.S. fiscal policy which has helped raise interest rates to extraordinary high levels were the chief contributors to the absence of enough foreign exchange to service much Latin American debt.

The current mix of U.S. macroeconomic policy, with, at least until recently, a relatively tight monetary policy, and loose fiscal policy, has redistributed domestic income to debt holders, and it would seem that it has had a similar impact on a number of Latin American countries.

The prospects for Latin American countries are debatable. What is going to happen in the future is debatable. The consensus estimate seems to be that if a number of key factors go reasonably well, that there may be no serious problems.

The problem is that all too often in life, and in politics and in economics, the consensus estimate winds up being wrong. I don't know what the probability of that is, but it is something that we need to take into account. I think we're not just dealing with what we each think is probably going to happen. We're also dealing with questions of the degree of risk associated with any policies that we follow. And even if the risk is less than 50–50, often if the consequences of that scenario being true are serious enough, the risks are very much higher than any rational country would like to encounter.

To help us assess the economic and financial and political outlook, we have assembled a panel of, I think, very credible experts: Larry Chimerine of Chase Econometrics will lay out for the committee several different economic futures for the United States, several different scenarios that we might encounter; Karin Lissakers, former Deputy Director of Policy Planning in President Carter's State Department, will assess what the high level of Latin debt could mean for the U.S. financial system; and finally, Bob Hormats, currently vice president, Goldman, Sachs and most recently, the Assistant Secretary of State for Economic and Business Affairs, will lay out the impact of the debt crisis and economic trends on the political future of individual Latin American countries and have a few other things to say as well.

I hesitate always quoting newspapers, magazines, or anybody else that can be remotely—well, never mind. I won't say what I was going to say. [Laughter.]

But I do want to refer to the latest issue of "The Economist," which said as follows: "Every serious study of international debt concludes that the Latin American debtors, now that they have changed their policies, can service their billions and expand their economies if OECD growth averages 3½ percent a year for at least 5 years. With 3 percent, it would be touch and go. Anything less would mean revolution and/or defaults."

I don't know whether the panelists think that that's optimistic, pessimistic, or irrelevant, but why don't I ask all of you how you feel about it, starting with Mr. Chimerine.

STATEMENT OF LAWRENCE CHIMERINE, CHAIRMAN AND CHIEF ECONOMIST, CHASE ECONOMETRICS, BALA CYNWYD, PA, ACCOMPANIED BY ROMUALDO A. ROLDAN, VICE PRESIDENT AND DIRECTOR, DEVELOPING COUNTRIES SERVICES

Mr. CHIMERINE. Thank you very much, Mr. Chairman.

I am delighted to be here. I'd like to begin by introducing my colleague, Aldo Roldan, who was primarily responsible for preparing the statement this morning and, quite frankly, is much more expert on the LDC debt situation than I am. He heads up our developing country analysis at Chase Econometrics.

I would like to summarize very briefly the prepared statement which we've submitted this morning, which, hopefully, will be made a part of the record, and focus on the essential issues that you raised in your introductory remarks.

No. 1, particularly in view of the U.S. economic slowdown—is worldwide economic growth sufficient to prevent a significant worsening of the LDC debt crisis? What could trigger a worsening of that crisis? And third, if it did deteriorate and if LDC debt problems resurface again, how will that feed back on the U.S. economy, because, as you correctly pointed out this morning, this is an interactive problem. What happens in the United States and other industrialized countries has a big effect on the Latin American countries. But, of course, it's now working in the opposite direction as well.

I'd like to begin by very briefly reviewing what's happened in the last several years among the high debt countries and talk about the status of the U.S. economic situation and, to some extent, Europe and other OECD countries as well, and then draw some conclusions about what this all means for the future for the LDC's.

You're all aware of the tremendous improvements that have been made among the high debt countries in recent years. It shows up primarily in what has been an astounding turnaround in the trade balance of high debt countries. If you take the 17 highest debt countries, they've converted what was an $8½ billion trade deficit in 1981 to a $40 billion trade surplus in 1984, which is a much sharper turnaround, I think, than anyone had expected at that time.

There are two principal reasons for it. No. 1, the enormous austerity measures that they've been forced to take within their own countries, which have resulted in the sharp decline in their own merchandise imports. And, second, a large increase in exports, particularly to the United States, and that, of course, in part reflects the rapid recovery we have had in the United States in 1983 and the first half of 1984.

These are the two principal factors. It has been that increase in their trade deficit and the resulting improvement in the current account balance that has enabled them to service their debt more easily, on top of the debt rescheduling that has taken place during this period.

As a result of the improvement in their trade balance, the growth in their debt has slowed dramatically. And, in fact, their debt-to-income ratio seems to be stabilizing for the first time in many years. So, clearly, there has been a significant improvement in the LDC debt situation in recent years. And, in fact, over the last year or so, economic growth has resumed in several of the high debt countries as well.

I don't think that anyone, however, Mr. Chairman, should understate the significant costs that have been involved here. Import controls and tariffs have been instituted among some of the high debt countries. Domestic currencies were sharply devalued. There has also been enormous inflation, accelerating inflation, in many cases, and a dramatic reduction in domestic purchasing power in almost all of these high debt countries.

In fact, income per capita in most of these countries now is substantially below where it was 3 or 4 years ago before the debt problem surfaced.

So there has been an enormous cost involved, underlying the improvement in the LDC debt situation in the last several years.

Our assessment of the situation right now is similar to what you pointed out in your introductory remarks, Mr. Chairman. It's a very close call because we tend to agree that without at least 3 percent real growth in the OECD countries, it will be hard to sustain the improvement that the high debt countries have experienced in recent years. And, in fact, the trade surplus among the high debt countries is already eroding in 1985, in part because of slower economic growth in the United States and, of course, in part because of the acceleration of growth in the high debt countries has stimulated demand for imports.

We believe, however, that 3 percent real growth on average will be sufficient to generate enough demand for high debt countries' exports that they can sustain the kind of improvement in their debt situation they've had in recent years. While this will require some additional external financing, it will be significantly less than they've had in recent years and is very likely to be manageable provided that the world economy continues to grow at 3 percent.

And the recent decline in interest rates will also help. While it's hard to be precise, each percentage point decline in world interest rates probably reduces high debt country interest costs by something like $4 billion a year. And if interest rates stay permanently lower, this tends to build on itself as time goes by, and that will to some extent offset the decline in their trade surplus that they're experiencing in 1985 because of slower economic growth in the United States.

In sum, what we're saying is, first, if U.S. economic growth continues or, in fact, accelerates somewhat, and, of course, the signs are mixed right now and I'll get into that in a moment; second, if economic growth in Europe, Canada, and Japan averages at least 3 to 3½ percent during the next several years; and, third, if the recent decline in interest rates in the United States and elsewhere is sustained, we probably will muddle through the next several years. That is, the trade surplus among the high debt countries will start improving slowly again. Their interest costs will be lower. The amount of new external financing they need will be relatively modest and manageable, and while a crisis will crop up on occasion, like has recently happened in Argentina, and while some specific reschedulings might be necessary, it is unlikely under those conditions that we will see a massive worsening on a widespread basis of the LDC debt situation.

Anything less than that, meaning a U.S. recession, in particular, or a return to stagnation in Europe, and/or a reversal of the recent downtrend in interest rates, will make it very tenuous and most likely, the amount of external financing that the LDC's will need under those conditions will be so large that it will be virtually impractical, which means that they would have to undergo more austerity measures. And as you pointed out earlier, given the political climate in these countries, that is a very difficult problem right now. Therefore, it is essential that worldwide economic conditions be favorable in order to ensure that the crisis does not worsen on a widespread basis.

I think that raises the issue of what's happening in the United States.

As you well know, this rapid economic recovery that we had in 1983 and the first half of 1984, which was exaggerated in the first place because it came from a very depressed level, nonetheless has decelerated dramatically. Over the last 12 months, economic growth in the United States has slowed to only a little bit more than 2 percent. The industrial sector has completely stagnated and, quite frankly, based on the feedback that we get from our clients, there is no sign yet that conditions are beginning to improve in the industrial sector. In fact, a number of industries are going in reverse, including some of the high-technology industries, as you know.

A major reason for that, in our judgment, has been the policy mix in the United States in recent years, which we've discussed previously at these hearings. You also pointed out, Mr. Chairman, in your introductory remarks, these massive Federal deficits, combined with somewhat restrictive monetary policy, have kept real interest rates in the United States and elsewhere extremely high and have kept the dollar extremely overvalued on world markets.

These are the two dominant factors that have limited economic growth in the United States in the last 12 months and that threaten a recession now.

So I'm delighted to see a shift in that policy mix and our judgment is that the economy will start to improve and grow closer to the 3-percent long-term average that we think is absolutely essential, not only for U.S. economic conditions, but also to avoid any worsening of the LDC debt problem.

With respect to Europe, conditions are mixed, as you know. Several European countries are growing very slowly, at best. Others have accelerated somewhat. Japan is growing quite rapidly and Canada seems to be experiencing adequate growth.

The key, though, on a worldwide basis, in our judgment, is lower interest rates, and a lower U.S. dollar, which will enable countries overseas to pursue more expansionary domestic policies because the limiting factor in economic growth outside the United States has been weak domestic demand, which is primarily the result of very restrictive fiscal and monetary policies in most of those countries. In turn, in our judgment, that reflects the strong dollar. They have tried to prevent their currencies from weakening even further and, as a result, have adopted these restrictive policies.

We feel very strongly, from a macrostandpoint, the best thing we can do in this country to prevent a worsening of the LDC debt crisis is to continue to shift the policy mix we've had in recent years by taking even stronger steps to reduce Federal deficits, including some modest tax increases, which we believe will be necessary to accomplish that.

At the same time, we should continue to ease monetary policy, by moving away from extreme monetarism, particularly in today's environment when M-1 numbers mean very little because they're distorted by the increase in import penetration in the United States. And if we continue to keep interest rates lower and ultimately bring the dollar down, we feel reasonably confident that we will muddle through with the LDC's and, as I said earlier, not experience a widespread worsening of the crisis.

Now, if that doesn't happen, if we do slip into a recession and/or if Europe stagnates, or other countries stagnate, there is little question but that the LDC debt problem will become unmanageable, and, as I mentioned earlier, one of two things will have to happen—either the amount of external financing will have to rise sharply, back toward the levels we experienced 4 or 5 years ago when they were increasing their debt in the range of $50 to $75 billion a year—and that strikes me as being unlikely in view of the exposure that the banks already have—or, second, they will have to implement more austerity programs to cut their imports further, which would only worsen living standards and purchasing power even further. This seems to me also to be a solution that is very unlikely, which raises the potential for widespread defaults and financial bankruptcies and a crisis that I think none of us would like to think about.

So the alternatives here aren't very good. The only solution, it seems to us, is to promote an economic environment in the OECD countries of continued economic growth, low interest rates, and ultimately, a lower dollar, as the best way to prevent worsening of the LDC debt problem.

One last comment, Mr. Chairman. And that relates to what would happen to the U.S. economy if, in fact, the LDC debt crisis worsens again? And now I'm talking about the feedback effects, if, in fact, conditions deteriorate in some of the high debt countries. The markets for many goods produced in the United States have deteriorated dramatically in recent years in many of these countries—our ability to export has been limited dramatically as a result of their cutbacks in imports—and depending on which estimate you choose, we've probably lost anywhere from 500,000 to 800,000 jobs in the United States, resulting directly from the decline in U.S. exports to the LDC countries. And, of course, it has an adverse effect, obviously, on GNP and other measures of economic performance in the United States.

Our own judgment is that if the U.S. economy were to enter a recession, and this, in turn, worsened the LDC debt situation, this will then have adverse feedback effects on the U.S. economy and, in fact, make any recession here even worse. And it will happen for two reasons—No. 1, our exports would diminish further, although not as dramatically as in recent years because, in many cases, they have cut their nonessential imports from the United States as much as they can. But, nonetheless, there is the potential for losing another 200,000 or 300,000 jobs related to a decline in U.S. exports to the LDC countries.

And second, and this is the thing that's very difficult to wrestle with, we run the risk of having financial problems in the United States, through bankruptcies and through the adverse effects on the financial system in the United States. In our judgment, that is a far more serious risk and will have much more serious consequences than simply the job loss or the loss of exports if the LDC debt situation worsens.

No matter how you look at it, therefore, it is essential that we avoid that by continuing to shift the policy mix in the United States to ensure continued economic growth and low interest rates. That, from a macroeconomic standpoint, is the best way to prevent the LDC debt problem from resurfacing. Thank you, Mr. Chairman.

[The prepared statement of Mr. Chimerine follows:]

PREPARED STATEMENT OF LAWRENCE CHIMERINE

Economic Prospects for the High Debt Countries and their Consequences on the U.S. Economy

My name is Lawrence Chimerine, and I am Chairman and Chief Economist of Chase Econometrics. It is an honor to testify before the Joint Economic Committee on the foreign debt situation and its consequences for the U.S. economy. Mr. Aldo Roldan, Vice President, and Director of Developing Countries Services, and his staff are primarily responsible for the preparation of this report. In sum, we believe the most likely scenario is that the foreign debt crisis is not likely to worsen significantly in the next several years. This depends, however, on the assumptions that the U.S. economy will not slip into a recession, but, in fact, that U.S. economic growth will accelerate somewhat from the recent sluggish performance; that economic growth in other industrial countries will pick up; and that the recent decline in the U.S. and world interest rates will not be substantially reversed.

I. The Present Situation

Three years after the onset of the foreign debt crisis, high debt countries and the world economy probably fared better than the most optimistic assessments made at the time. The crisis failed to disrupt the international system of payments and financing, or provoke widespread commercial lender bankruptcies. Nor did it lead to the creation of a debtor countries cartel, or to massive political unrest in the countries affected. In short, the adjustment to what looked like unsurmountable problems was a gradual one, not a painless one, but one well within the capabilities of international cooperation and finance arrangements, of the internal and external economic policy adjustment mechanisms, and of adaptation of commercial lenders.

The experiences of 17 high debt developing countries with an aggregate debt of $471 billion at the end of 1984 provide clear illustrations of the types of adjustments to the foreign debt crisis that have occurred. The external sector of these economies underwent profound transformations. Merchandise imports declined approximately $44 billion in the 1982-83 period, or an equivalent 27 percent drop from 1981 levels. Despite the contraction in merchandise exports these countries experienced during that period as a consequence of the concurrent world recession and decline in commodity export prices, the savings on foreign purchases led to a reversal in the trade balance from a deficit of $8.5 billion in 1981 to a $26.5 billion surplus in 1983. Helped by a surge in the debtor countries exports resulting from the U.S. economic recovery and sharp devaluations of their domestic currencies in the previous two years, this trend continued during 1984, when the aggregate merchandise trade surplus reached an unprecedented $40.6 billion, as shown in **Table I.**

Table I

High-Debt Countries Economic Performance

	1980	1981	1982	1983	1984
I. Economic Activity and Prices (Percent)					
GDP Growth	4.3	0.9	-0.4	-1.2	1.6
Per Capita GDP Growth	1.8	-1.6	-2.8	-3.6	-0.9
Capital Expenditures Growth	4.0	-2.3	-7.9	-9.1	-3.5
CPI Inflation	46.4	49.4	55.0	65.4	102.0
II. External Sector ($ Billions)					
Merchandise Exports	152.1	153.3	140.7	144.4	161.9
% Growth	29.8	0.8	-8.2	2.6	12.1
Merchandise Imports	146.7	161.8	139.3	117.8	121.2
% Growth	26.5	10.3	-13.9	-15.4	2.9
Trade Balance	5.4	-8.5	1.4	26.5	40.6
Current Account Balance	-29.5	-54.4	-55.3	-24.7	-16.9
Interest Payments	27.9	40.1	44.3	41.4	47.9
Foreign Debt	283.6	346.5	400.9	440.3	470.8
Change in Foreign Debt	55.0	62.9	54.4	39.3	30.5
(Percent)					
Foreign Debt/GDP	28.3	32.0	40.7	50.2	51.4
Current Account Balance/GDP	-2.9	-5.0	-5.6	-2.8	-1.8

Note: The 17 high debt countries included here are: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Korea, Malaysia, Mexico, Morocco, Nigeria, Peru, Philippines, Thailand, Uruguay, Venezuela, and Zaire.

The combined balance in the current account for these high debt countries underwent a similar improvement, declining from a $55 billion deficit in 1982 to a $19.4 billion deficit in 1984. Outlays for interest payments included in the current account began to stabilize during this period due to the slower expansion of the external indebtedness and the downward trend in international interest rates in 1984.

Although the improvement in the external accounts was not sufficient to prevent these countries from requiring additional increases in their foreign indebtedness, the performance so far indicates that the decline of some debt burden measures (the current account deficit as share of GDP declined from 5.6 percent in 1982 to 1.8 percent in 1984) and the slower rise in others (the ratio of foreign debt to GDP rose to 50.2 percent in 1983 from 40.7 percent in 1982, but only to 51.4 percent in 1984) suggest an improvement in the high debtor countries capacity to pay, or at least service, their foreign obligations.

These adjustments, however, did not come without significant costs: stiff import controls and tariffs were instituted in many instances, while domestic currencies were sharply devalued, triggering inflation and reductions in domestic purchasing power. Workers saw their take home pay decline as a result of restrictive wage policies. Fiscal austerity attempting to eliminate chronic deficits reduced government current expenditures and investments. GDP declined an unprecedented 0.4 percent in 1982 and 1.2 percent in 1983, while recovering meagerly during 1984. Capital formation expenditures experienced a sharper decline of an accumulated 19.2 percent during the three-year period. Given the steady growth in population, income per capita declined more sharply than GDP. Although recessionary conditions were common to most debtor countries, the magnitude of the output declines differed markedly from country to country. Income per capita losses in the most affected countries were substantial as shown in **Table 2** and it may take past the present decade for them to recover to earlier peaks.

The steep losses in terms of output, employment and standards of living brought about by economic adjustment programs, often instituted under the aegis of the International Monetary Fund, met a substantial degree of domestic political opposition and discontent. Additional resistance to the process of adjustment originated from the fact that the net financial resource transfer to the high debt countries (net increase in their foreign indebtedness minus their interest payments on their external debt) went from a strong inflow during the pre-1982 period of rapid increase in indebtedness—amounting to $22.8 billion in 1981—to an outflow of $17.4 billion in 1984 as the foreign debt crises set in. That outflow was equivalent to roughly 2 percent of these economies' output of goods and services for that particular year.

Table 2

High Debt Countries
1984 Income Per Capita
(1980 Dollars)

	1984	Peak Year	1984 Income Per Capita as Percentage of Peak Year
Argentina	4,495	1977	86.3
Bolivia	667	1978	68.9
Brazil	1,888	1980	91.9
Chile	2,210	1981	85.6
Colombia	1,255	1981	98.3
Ecuador	1,312	1981	91.1
Korea	1,921	1984	100.0
Malaysia	2,004	1984	100.0
Mexico	2,547	1981	90.2
Morocco	868	1980	97.7
Nigeria	742	1977	68.3
Peru	952	1975	81.6
Philippines	678	1982	90.5
Thailand	818	1984	100.0
Uruguay	3,000	1981	85.1
Venezuela	3,007	1977	75.2
Zaire	194	1974	67.1

Often during the last three years, these costs took their toll in terms of the willingness of the political bodies and governments to continue or deepen the domestic adjustment process, even at the risk of forfeiting additional official and commercial bank external funding. Some countries declared moratorium (or fell into arrears) on interest payments owed to commercial banks, rejected stabilization programs proposed by the IMF, or simply defaulted on the programs already agreed to, or replaced economic policymakers by individuals advocating economic recovery strategies in open conflict with standard IMF guidelines. Without significant exceptions, countries came to reverse those stands and continued attempts at improving their external accounts and restoring internal equilibrium, lured partly by additional and more favorable financing conditions and partly by their hesitation to enter into an open default situation and risk the consequences of severance of their international economic links.

On the external creditors side, a significant adaptation to the new circumstances has taken place. Early on, the International Monetary Fund assumed a leadership position to maintain commercial credit lines for the countries requiring assistance. Implicit in the arguments that persuaded the international banking community to renegotiate amortization payments, grant additional long-term financing, and maintain short-term credit lines—all through complicated ad hoc, nonmarket mechanisms—was the IMF seal of approval of the debtor countries' policies designed to improve their external cash flow and to regain a more fundamental external and internal economic equilibria, and, very importantly, the IMF financial resources that would support the countries transition.

During the three-year period, the adjustment of lenders to the new situation has been far from perfectly smooth and not completely devoid of costs. Commercial banks have had to increase their loan loss reserves in some cases and write-off loan losses in others. Trepidation at granting rollovers, extensions and increasing their exposure in the debtor countries was fueled by interest and principal payments arrears. Early during the crisis, during 1983, a major concern was the design of mechanisms that would ensure the continuation of commercial bank lending. Generous spreads and commitment fees were accompanied by peer pressure to encourage bank commitments. More recently, however, commercial lenders have began to consider alternative financing proposals that moved away from the "crisis management" approach toward one that takes a longer-term view of debtors' financing needs, and introduces some elements of concession in lending terms.

II. Prospects for Debtor Countries

Given the present economic trends worldwide, characterized by resumption of industrialized country growth and declining interest rates, and taking into account the experience of the last three years, the future prospects for the foreign debt crisis continue to be relatively optimistic overall, for the following reasons:

(a) Despite the reversal in foreign trade gains in recent months, derived from higher domestic economic activity levels that have accelerated import growth, and slower export revenue expansion due to the moderation in the U.S. economic expansion and high U.S. dollar exchange rates, the situation does not indicate a collapse of the positive trends in the trade balance, but simply an adjustment to a more stable longer term situation. Although the combined trade surplus for the high debt countries will decline to $34.8 billion in 1985 from $40.7 billion a year earlier, Chase Econometrics anticipates a slow but steady improvement in the balance reaching approximately $41 billion by 1989 (see **Table 3**). Continued growth in the world economy and strong incentives to exports achieved by realistic exchange rates will be reflected in rising shipment volumes, while commodity export prices should benefit by a decline in the dollar strength and rising world demand. Import growth, on the other side, will remain subdued in view of the slow growth anticipated in high debt countries' aggregate demand.

(b) High debt countries economic activity has resumed positive growth, albeit, within the limits imposed by continued austerity, making possible some progress toward a recovery of employment levels and purchasing power, thereby reducing the political opposition to stabilization programs.

(c) The reduction in the trade surplus envisioned for 1985 and its slow improvement in future years are being compensated by lower than anticipated interest rates in the short and medium term. Just six months ago, debtors and lenders financial projections were based on interest rates that are now being revised by 250 to 350 basis points. Present projections indicate that interest payments on foreign debt for the high debt countries will decline to $46.1 billion in 1985 from $47.9 billion in 1984, and that they will decline further to $41.3 billion in 1986.

(d) The projections for the external debt levels, consistent with this scenario, do not seem excessive from the point of view of international lenders. Assuming that short term lending is likely to rise at approximately the rate of the debtor countries' dollar import growth and that official credits will remain constant in real terms (that is, will grow at approximately 5 percent per annum in accordance with recent IMF projections), private, long-term lending should account for the difference between the projected external debt level and the other two credit categories. As shown in **Table 4**, long-term debt is expected to grow during the forecast period, at rates that would imply some reduction in real terms. Assuming, as some international bodies and some industry observers suggest, that long-term exposure by private lenders could conceivably grow at an annual rate of 5 percent, without implying an assumption inordinate of additional risk, private long-term debt could rise to $431 billion in 1989, or $32 billion above the level expected in these projections, without reaching funding constraints.

Table 3

Future Economic Prospects High Debt Countries

I. Economic Activity and Prices (Percent)

	1984	1985	1986	1987	1988	1989
GDP Growth	1.6	2.9	3.6	3.8	4.6	4.5
Per Capita GDP Growth	-0.8	0.5	1.2	1.4	2.2	2.1
Capital Expenditures Growth	-3.5	2.8	5.3	6.1	7.3	6.8
CPI Inflation	102.0	90.2	61.7	48.2	42.2	37.6

II. External Sector ($ Billions)

	1984	1985	1986	1987	1988	1989
Merchandise Exports	161.9	169.2	184.9	202.1	223.5	246.6
% Growth	12.1	4.5	9.3	9.3	10.6	10.3
Merchandise Imports	121.2	134.4	148.9	164.8	184.7	205.6
% Growth	2.9	10.9	10.8	10.7	12.1	11.3
Trade Balance	40.7	34.8	36.0	37.3	38.8	41.0
Current Account Balance	-16.9	-19.4	-14.1	-20.6	-23.2	-21.0
Interest Payments	47.9	46.2	41.3	46.8	48.6	47.7
Foreign Debt	470.8	494.7	511.5	536.4	565.4	594.0
Change in Foreign Debt	30.5	23.9	16.8	24.9	28.0	28.6

(Percent)

	1984	1985	1986	1987	1988	1989
Foreign Debt/GDP	51.4	53.3	53.6	54.3	53.2	51.3
Current Account Balance/GDP	1.8	2.1	1.5	2.1	2.2	1.8

III. External Assumptions

	1984	1985	1986	1987	1988	1989
LIBO Rate, 3 months	11.6	9.9	9.5	9.5	9.5	9.5
OECD GDP Growth	4.8	3.0	2.4	3.2	2.8	2.9
U.S. GNP Growth	6.8	2.9	2.4	3.9	3.0	3.0

Table 4

High Debt Countries
Base Forecast Composition of the External Debt
($ Billion)

	1984	1985	1986	1987	1988	1989
Total Debt	470.8	494.7	511.5	536.4	565.4	594.0
Annual growth (%)		6.9	6.1	4.8	3.6	3.2
Short-Term Debt	58.9	65.3	72.3	80.0	89.7	99.9
Annual growth (%)		10.9	10.8	10.7	12.1	11.3
Official Long-Term Debt	74.4	78.1	82.0	86.1	90.4	95.0
Annual growth (%)		5.0	5.0	5.0	5.0	5.0
Private Long-Term Debt	337.5	351.3	357.2	370.3	385.3	399.1
Annual growth (%)		4.1	1.7	3.7	4.1	3.6

Despite this upbeat assessment, there are still some aspects of the foreign debt crisis that continue to be troublesome. For the most part, they arise from the still apparent inability of major high debt countries to correct some of the domestic distortions that were at the root of the early excessive increases in external debt and of their inability to render some of that borrowing into fully productive investment in the past. Although a moderate early success has been achieved on the countries domestic management, fiscal deficits, subsidies, and other forms of market intervention continue to prevent further progress. Inflation has continued on an upward trend fed also in part by the reluctance of the various internal groups to assume the cost of the adjustment, triggering a spiral of wage adjustments and inflation. Moreover, inflation forecasts give little hope for a quick reversal in those trends.

External funding will continue to be a critical aspect of foreign debt crisis management; this will introduce strong self correcting forces into the situation because reluctance of commercial creditors to commit funds to countries where a breakdown in stabilization programs occurs effectively linking the external financing constraint not only to the external accounts performance but to the achievement of sound domestic economic management. In addition, although the willingness of international lenders to finance the foreign debt crises has been traditionally regarded as a decision dealing with net increases in exposure, it is clear that the safety of the principal is also a crucial consideration. The decision to lend for purposes of rollover of outstanding debt, which involves far higher volume of funds, is governed by country risk considerations.

This year, once again, IMF financing agreements have been temporarily suspended in many countries in order to pressure economic policy into a more austere stand, and the refinancing agreements with foreign commercial creditors have been delayed until new policy targets are clarified. External cash flow shortages have reappeared and payments arrears have grown larger in some cases. Will the situation reach a point of crisis? We believe it is quite unlikely. Debtors' cartel initiatives have failed to materialize and countries are less willing today to risk the unforeseen costs of an open default. The situation will continue to muddle through, even in the most serious cases, as illustrated by the recent economic measures taken by Argentina. With no major disruptions taking place in the world economy, high debt countries are likely to slowly recover their lost standards of living. Progress in domestic economic management however will be slow as many governments remain fearful of testing the political limits of more radical economic programs.

An important question is what are the implications of the foreign debt crisis and related developments on the level of internal capital formation, that is on the ability of the high debt economies to generate adequate employment and business opportunities in the longer term. Chase Econometrics projections indicate that investment expenditures are likely to recover at a slow pace for the following reasons: **(a)** Restrictive monetary policies are likely to continue to reinforce the recent hikes in domestic interest rates, which will continue to remain positive in real terms. **(b)** Internal sources of investment financing have been depleted over the last two or three years of domestic recession and sharp increases in the cost of servicing foreign currency denominated debt. **(c)** The widespread elimination of subsidies and the sharp devaluations of domestic currencies have changed relative prices, modifying comparative advantages and altering the relative profitability of new investments. Careful reassessment of investment projects and priorities has begun to take place, unavoidably introducing longer time delays between the design and actual implementation of investment projects. **(d)** Utilization of plant capacity will only gradually improve, given the slow rates of output expansion anticipated, delaying capacity expansion plans. **(e)** Domestic inflation will continue at disturbingly high levels during most of the forecast period in many countries, discouraging domestic savings and capital spending by difficulting calculations of project viability and increasing the risk premium on investment funds. High inflation is also associated with wide fluctuations in relative prices, contributing to wide fluctuations in profit margins, thus further discouraging productive investment.

III. Vulnerability of High Debt Countries to World Economic Conditions

Two of the main external variables affecting the economic performance and prospects of the high debt countries are world economic activity and international interest rate levels. The process of transmission of these influences into their domestic economy is complex and multifaceted. The impact of a decline in, for example, OECD economic activity on borrowing countries would come via export revenue changes caused by export price and volume changes. The reduction in the volume of exports would directly impact domestic output and the ensuing reduction in the trade surplus, vis-a-vis the base forecast, would translate into a similar deterioration in the current account deficit. The financing of the added current account deficit becomes a crucial issue, given the inability of countries to freely tap external sources of funds. Two possibilities exist: **(a)** Countries would resort to domestic aggregate demand adjustments to reduce imports and keep their current account deficits unchanged. The output losses associated with this alternative will be smaller the higher the changes in import expenditures associated with a given variation in output; in other words, the higher the countries marginal propensity to import. **(b)** Debtor countries would be able to finance the additional interest payments by increasing their external borrowing. The feasibility of this alternative will be of course dictated by the availability of foreign funds; i.e., by the willingness of foreign lenders to increase their level of exposure concurrently.

In analyzing the impact of international interest rate variations on high debt countries, the more immediate effect is on the interest payments on their foreign debt. Given the key role played by interest rates in the determination of economic activity, exchange rates, and commodity prices, interest rate scenarios must also play particular attention to those linkages. Our contention, however, is that relatively small interest rate deviations from the base scenario—on the order of 1 percentage point—can be treated, as a fairly independent event, affecting interest payments but unlikely to produce a measurable effect on other external economic variables. For interest rate increases above that range, our scenario analysis specifically assumes the following effects: **(a)** Strengthening of the U.S. dollar, with a consequent decline in commodity prices. **(b)** Reduction in OECD economic activity, implying a reduction in commodity, oil, and manufactures import demand by the OECD, resulting in an additional downward pressure on world commodity prices. These factors would necessarily bring about a deterioration in the high debt countries' export revenues that will only be partially offset by a reduction in their import bills (which would benefit from lower import prices). As with the scenario that incorporates variation in world economic activity, the ensuing current account deterioration vis-a-vis the base forecast can be financed by additional external borrowings or by adjustments in the level of domestic aggregate demand.

Simulation exercises summarized in **Table 5** show the following sensitivities for scenarios incorporating a one percent permanent reduction in OECD growth vis-a-vis the base projection assumptions, and separately, a one percent permanent increase in the assumed levels of interest rates.

(a) The decline in the OECD growth rate, if additional external financing is available to high debt countries to cover the projected additional current account deficits, will imply a 0.3 percent decline in the GDP growth rate for those countries during the first year of the simulation. If the debtor countries are forced to adjust by reducing the level of their imports, the ensuing output losses imply a permanent reduction in their GDP growth rate of 1.5 percentage points during the first year and of 1.1 percentage points in subsequent years. This last estimate is particularly sensitive to the assumption with regard to the debtor countries marginal propensity to import, that has roughly been on the order of three during the last three years of the foreign debt crisis. If lower assumptions are made for this parameter, considering that most of the easy import reductions have already taken place, the output losses will be magnified.

(b) The one percent permanent rise in interest rates, would have a negligible impact on high debt countries' economic activity if foreign financing is available. Lack of financing, however, will imply a one percent decline in their GDP growth rate for the first year of the shock.

(c) The additional exposure of international lenders by the fourth year of the simulation (1989) under the assumption of full availability of external financing, is of $93 billion in the case of the decline in OECD growth scenario and $24 billion in the case of higher interest rates. Comparing these figures with the projected foreign financing leeway of $32 billion described above for the base projections indicate that funding is likely to meet resistance, particularly in the first case, from international commercial lenders.

Thus, it is clear that significant downward risks exist regarding the foreign debt situation. The base case scenario of modest U.S. economic growth, a pickup of economic growth in other industrialized countries (especially Europe), and continued low interest rates suggests that the debt crisis is manageable. If, however, interest rates should back up, or if the U.S. sinks into recession and/or Europe remains stagnant, it will be very difficult for many of these debtor countries to service their debts without significant further austerity measures in view of the difficulties they are likely to encounter in receiving more credits from outside financial institutions.

Table 5

High Debt Countries Scenario Analysis

	1986	1987	1988	1989
1. One percentage point decline in annual OECD GNP growth. Additional external financing.				
Current Account Balance ($ billion)				
Base Forecast	-14.1	-20.6	-23.2	-21.0
Scenario	-24.6	-38.4	-50.3	-58.9
Foreign Debt ($ billion)				
Base Forecast	511.5	536.4	565.4	594.0
Scenario	522.0	564.7	620.7	687.3
GDP Growth (percent)				
Base Forecast	3.6	3.8	4.6	4.5
Scenario	3.1	3.8	4.6	4.5
2. One percentage point decline in annual OECD GNP growth. No additional external financing.				
GDP Growth (percent)				
Base Forecast	3.6	3.8	4.6	4.5
Scenario	2.1	2.7	3.5	3.4
Note: Foreign debt and current account balance unchanged.				
3. One percent permanent rise in interest rates. Additional external financing.				
Foreign Debt ($ billion)				
Base Forecast	511.5	536.4	565.3	594.0
Scenario	516.5	547.0	582.3	618.3
Note: GDP unchanged.				
4. One percent permanent interest rate rise. No additional external financing.				
Interest Payments ($ billion)				
Base Forecast	41.3	46.8	48.6	47.7
Scenario	46.2	51.9	54.0	53.3
GDP Growth (percent)				
Base Forecast	3.6	3.8	4.6	4.5
Scenario	2.6	3.8	4.6	4.5
Note: Foreign debt unchanged.				

IV. Feedback Impact of Foreign Debt Scenarios on the U.S. Economy

We have considered two scenarios for the U.S. economy, examining their impact on the high debt countries, and then subsequently considering the additional impact that those changes would have on the U.S. economy in terms of employment and GNP.

The scenarios assume the U.S. GNP growth rate suffers a permanent 1 percent decline vis-a-vis the one anticipated in the base projections. For simplification purposes, we have assumed that this translates into an OECD growth decline of one percent each year. With a neutral monetary policy and the consequent decline in credit demand, we have assumed interest rate declines of 2 percentage points in the U.S. in the first scenario, with an equivalent impact on world interest rates. The following scenario assumes a restrictive monetary policy as an initial trigger to the lower U.S. and OECD growth condition. Under these circumstances, we have assumed that interest rates are higher by 3 percentage points every year.

Table 6 provides a summary overview of these particular scenarios for the high debt countries. The most pessimistic scenario with high interest rates implies, after a few years, an untenable position for these countries in terms of the needed financing to bridge the revenue shortage, or alternatively, in terms of foregone GDP in order to offset the deterioration in the current account. From a practical perspective, however, it is unlikely that the combination of higher interest rates and OECD slowdown will be maintained for a considerable number of years. This scenario, consequently, should be regarded as plausible in a short term, business cycle type of situation.

Considering the scenarios where the lack of external financing triggers aggregate demand reductions in the high debt countries (in particular, of import expenditures) it is possible to determine the feedback of those situations on the U.S. economy through the decline that they imply for U.S. merchandise export activity.

Table 7 provides a summary of those impacts in terms of foregone U.S. employment and GDP losses. The more pessimistic scenario indicates that 100 thousand jobs could be lost during the second year and tha the losses could mount quickly reaching 220 thousand jobs during the fourth year. Thus, a U.S. recession and/or higher U.S. interest rates that aggravates the foreign debt problem will have unfavorable feedback effects for the U.S. economy and thus would deepen the downturn. The feedback effect will be fairly modest, however, since much relatively non-essential U.S. exports to many high debt countries have already been cut dramatically.

Table 6

High Debt Countries Combined Scenario Analysis

	1986	1987	1988	1989
1. One percent decline in OECD growth plus two percent lower interest rates. Additional external financing				
Current Account Balance ($ billion)				
Base Forecast	-14.1	-20.6	-23.2	-21.0
Scenario	-14.7	-27.3	-37.7	-44.8
Foreign Debt ($ billion)				
Base Forecast	511.5	536.4	565.4	594.0
Scenario	512.1	543.7	587.1	639.6
GDP Growth (percent)				
Base Forecast	3.6	3.8	4.6	4.5
Scenario	3.1	3.8	4.6	4.5
2. One percent decline in OECD growth plus two percent lower interest rates. No additional external financing.				
GDP Growth (percent)				
Base Forecast	3.6	3.8	4.6	4.5
Scenario	3.0	2.7	3.5	3.4
Imports (billion)				
Base Forecast	148.9	164.8	184.7	205.6
Scenario	145.8	153.6	163.5	173.0
3. One percent decline in OECD growth plus three percent higher interest rates. Additional external financing.				
Current Account Balance ($ billion)				
Base Forecast	-14.1	-20.6	-23.2	-21.0
Scenario	-39.4	-55.0	-69.2	-80.2
Foreign Debt ($ billion)				
Base Forecast	511.5	536.4	565.4	594.0
Scenario	536.8	596.2	671.9	759.0
GDP Growth (percent)				
Base Forecast	3.6	3.8	4.6	4.5
Scenario	3.1	3.8	4.6	4.5
4. One percent decline in OECD growth plus three percent higher interest rates. No additional external financing.				
GDP Growth (percent)				
Base Forecast	3.6	3.8	4.6	4.5
Scenario	2.1	2.5	3.3	3.2

Table 7

Feedback Impact on the U.S. Economy of Alternative High Debt Countries Scenarios

	1986	1987	1988	1989
1. One percent decline in OECD growth plus two percent lower interest rates. No additional external financing.				
Decline in Employment (thousand workers)	0.0	10	30	70
Decline in GNP ($ billion 1972 prices)	0.5	.91	2.12	3.14
2. One percent decline in OECD growth plus three percent higher interest rates. No additional external financing.				
Decline in Employment (thousand workers)	20	100	170	220
Decline in GDP ($ billion 1972 prices)	3.68	4.83	6.28	6.63

Representative **Obey**. Thank you. Why don't we go right down the table? Mr. Hormats.

STATEMENT OF ROBERT D. HORMATS, VICE PRESIDENT, GOLDMAN, SACHS & CO., NEW YORK, NY

Mr. **Hormats**. Thank you, Mr. Chairman. The analysis that we've just heard is one that I find myself very much in agreement with in terms of the key elements in U.S. policy, U.S. growth, and the broader implications of the deterioration in the situation.

Let me try to describe very briefly some of the major factors that I see involved in this situation. In particular, I think that we should be careful to draw a distinction between the very impressive improvement in trade performance of these high debt countries and their internal adjustment. There's a big difference between the two.

As a result of growth in the United States, exchange rate devaluations in a number of the high debt countries, and very tight fiscal and monetary policy in many of these countries, their trade balances have improved rather substantially.

Internal adjustment, however, has been far more difficult, far more painful, and much slower. In many cases, the internal adjustments involved important structural changes that require capital. The capital is not there in many of these difficult situations because they simply can't borrow additional sums of money. Also, internal structural adjustment is much more difficult politically. And I think we have seen in a lot of these countries that while they have done what is necessary to improve their debt situation numerically, a lot of internal difficulties still remain. I will just go over them very briefly.

One, unemployment is extremely high. Unemployment in most of the Latin American countries today is about the same as it was during the Great Depression. It's very, very high, particularly in the cities and particularly among younger people: That gives rise to pressures for more emigration, a lot of crime, a lot of social discontent. And while we can look at the numbers and perhaps be relatively optimistic, the underlying circumstances in these countries is a political tinderbox.

So far, I have been most impressed with the way countries have been able to deal with these political pressures, but one doesn't know how long that can continue.

Second, we have to be careful to differentiate among the types of debtor countries. There are really three broad types. There are the big Latin debtors. And the big Latin debtors have been adjusting reasonably well in their external accounts, although, as I say, there are lots of internal problems still to be reckoned with.

Second is the middle tier of Latin countries. Those countries—Bolivia is an example—today are in what might be called a state of suspended default. They're not paying their debts on time. They're not paying their interest on time. But they're not in default because the banks haven't called them in default. The banks haven't said, you're in default—with all the messy legal problems that that would entail. So they're really in a state of suspended default. Basically, that's going to continue. And don't forget, that suspended default situation has occurred in an environment where the United States has been growing relatively rapidly.

Third, there are the African countries, who have an enormous debt problem, but it's mainly official debt rather than commercial debt, and therefore, we tend to put it in a different category.

Now, what's likely to happen to these countries and what does it mean for us?

It seems to me that the key, really, in many of these countries is what happens in the U.S. economy? I think that point is very well taken.

One alarm bell that has begun to ring is when we saw the weak U.S. statistics of the first and early part of the second quarters, people began to worry about what this meant for the debt situation. Rightly so, because it has in large part, been the very strong American engine which has helped a number of these countries to increase their exports. If the American engine begins to lag, then I'm afraid that we've got big problems.

As it was, even with substantial American growth, Argentina, Brazil, Chile, and Mexico saw their exports last year decline from what they were 1 year earlier—although Columbia, Equador, Peru, Venezuela, had increased exports.

But if the U.S. economy were to weaken dramatically, the exports of many of these countries would deteriorate quite fast.

Another problem is, if the United States imposes lots of restrictive measures against the exports of these countries, that would have a similar effect—reducing their ability to export. That would certainly sour them on the whole debt situation.

And a third problem is that the flows from abroad are weak. Many had felt that there would be somewhat of an increase in external flows. Those have increased, but not by enough.

Let me outline briefly three types of scenarios which could occur over the next, say, 2 to 3 years.

One is the scenario which is likely to occur if growth in the OECD remains reasonably high, say in the 3 to 3¼ percent range, there's no protectionism, and the high debt countries continue to remain committed to some type of adjustment, which is still very important.

I'll come back to that in a moment.

If that should occur, the big debtor countries are likely to be able to go through the situation with some pain, but with continued reasonable, although not rapid, progress.

The middle-size countries, I think, will find it very difficult to service their debts in a timely way. And there will probably be a number of renegotiations of stabilization agreements, renegotiations of rescheduling agreements, and a number of other problems. But, basically, the situation is manageable without too much disruption. And in the countries in which there would be disruption, the Bolivias and others, the disruption would be manageable.

The second scenario begins to loom larger on the horizon to the extent that the assumptions of 3, 3¼ percent growth and minimal protection are deviated from. To the extent that we don't live up to those assumptions, then the situation gets somewhat worse. Then you will see, I think, a number of the bigger countries coming in for very frequent renegotiations of debt rescheduling agreements and of IMF agreements. They'll make an effort to pay their debt on time, but they'll ask for considerably modified terms. And the little countries will ask for some sort of limited or partial moratorium—which is to say they will try to reach agreement on a situation which de facto exists today—they simply can't pay their debts. And they will ask for special terms by the banks or acquiescence in the situation.

The worst scenario is if the U.S. economy and others really suffer a major recession, or there's a lot of protectionism. Then I think you will see a lot of dramatically changed terms of repayment. IMF standby agreements will not be met. And a lot of the smaller countries will find themselves virtually unable to pay and will say, well, we'll pay you 5 or 10 percent of what we owe you. We can't do any better than that. And you have to accept that reality.

Now I'm saying these last two scenarios are not ones that I'm predicting, but I think that we have to be aware that if the situation deteriorates substantially, they're the types of things that we will, whether we like it or not, have to look for.

Then there's the question you raised in your opening statement, Mr. Chairman, the political risk—political stability.

The answer to that is we really don't know how much political pressure these countries can tolerate. We know in our own country that we can't get very much support for reducing the budget deficit by $50 billion. In these countries, we're asking governments to undertake very substantial austerity programs, eliminate social programs or cut them down, eliminate new development projects or postpone them for a period of time.

These are important political and economic and social adjustments.

Now I made the point earlier that adjustments have to continue. I think it is imperative that these countries continue to adjust. The reason that they got into these debt situations, in addition to the change in the international environment, was that they were borrowing to support a lot of development programs which were very expensive. They were borrowing for subsidies. They were borrowing for a lot of uses which they really shouldn't have borrowed for and which, quite frankly, the banks shouldn't have lent for.

It's a dual problem.

However one puts it, a certain amount of contraction is necessary, has been necessary, and will continue to be necessary.

The real issue is whether what is economically imperative is politically sustainable. And that we simply don't know. It differs from country to country.

So far, adjustment has been sustainable politically, quite remarkably in many cases. And we hope it can go on. But one has to always be aware that in some cases, it might not be able to go at quite the pace that we would like.

Now let me just identify—and we can probably discuss them a little bit later—three considerations that have to be borne in mind in addressing the situation.

The first is that we saw a big sea change in the world economy around the turn of the decade, when we went from an inflationary to an anti-inflationary environment. We went from low interest rates to high interest rates. People who borrowed in dollars saw the dollar shoot up and dollar interest rates shoot up.

In the future, we're going to have to do a lot more to help countries manage their borrowing and their liabilities in such a way as they're not quite as vulnerable to these major changes in the world economy.

Second, there are major differences among the developing countries today. Some have adjusted quite well. Some, like Korea, have, in fact, avoided the worst elements of the debt problem. And some have adjusted very poorly. It seems to me that they can learn a lot from one another. These countries might usefully compare experiences to determine which types of policies have been most successful, and which have been least successful. Because even in this cruel economic environment, some have done reasonably well. So it's not a fait accompli that all countries had to be in this serious debt situation. The right sort of policies could have mitigated the situation.

Third, the locus of world savings has dramatically shifted from the 1970's. OPEC in the 1970's was the big saver. Today, OPEC is an important saver, but Japan is a big saver. And within the industrialized countries, institutional savings—insurance companies, pension funds, and such things—are now big repositories of investable money. Somehow, ways need to be found to use that.

Now in terms of specific measures, let me just make a few general points. One, I think the key problem now for a number of these countries, and for us, is to help them to reduce their foreign exchange constraints. One reason we're not exporting much to them is that they simply don't have the foreign exchange to buy very much from us. When they earn foreign exchange, they repay a large portion to service their debt.

So one thing that has to be done is to find ways to increase export financing for these countries, using, to a degree, government support and, to a degree, private support.

Second, the World Bank has been toying with the idea of a bank's bank to try to use a higher gearing ratio to get more money into these countries, particularly for things like cofinancing. That should be encouraged.

Third, the International Finance Corporation of the World Bank is doing some imaginative and helpful things to support the private sector in these countries and the private sector in these countries is hurting very badly. This also needs support.

The fourth area that can be addressed is multiyear reschedulings. Mexico has received a very favorable multiyear rescheduling. Other countries that are in reasonable positions should be able to obtain the same thing.

Fifth, some way should be found to avoid an adverse impact on these high debt countries if, in fact, interest rates do increase substantially. There has been all sorts of talk about interest payment smoothing. It seems to me a number of these ideas are well worth pursuing.

Another area that I think is particularly important is the way the repayments to the IMF trust fund are used. This is one opportunity the world has to get some resources that are relatively uncommitted and use them to help deal with the debt situation. It strikes me that this committee could make an important contribution to that debate because the U.S. Government has not yet made a decision on what it will recommend to the IMF in terms of use of the repayments from the old IMF trust fund. And the amounts of those repayments are quite substantial. Those funds could well be used in some way to help support additional financing for some of the higher debt countries.

There are other areas that I'll talk about very briefly. One, trade is extremely important. The lack of multilateral trade negotiations reduces one constraint on this country and other countries to impose new import restrictions. And, concessional assistance is particularly important for the poorer countries of the world, particularly Africa, and some of the poorer countries of Latin America.

The private sector, as I mentioned, is a major problem in these countries. It's financially starved of resources. And there are ways of helping to refurbish that.

But these are some general points. They're covered more in my prepared statement.

I would simply say, in closing, that the situation remains serious, even though improvements have taken place. One has to look at different types of debtor countries. The overall problem, however, will be made much easier if there is growth in the industrialized countries. But even that will not solve the problems of some of the middle-tier Latin American countries. It won't solve some of the problems of the African debtor countries. And even with respect to some of the larger Latin American countries, there are lots of internal political and social pressures which could lead to major changes in policy or major social frustrations, even if the growth rates in the industrialized countries, particularly the United States, remain relatively strong.

We have here in the final analysis, a major problem—one that affects the U.S. national security, political, and financial interest.

The banking system is very vulnerable if one or two of these big countries should suffer major reverses. We focus a lot of our time and attention on Central America, and rightly so. There are big problems in Central America. But there are certainly major American interests in the rest of Latin America. And my fear is that we have, in a way, let Central America overshadow some of the vital American interests in South America. That is something that we have to overcome. Thank you.

[The prepared statement of Mr. Hormats follows:]

Prepared Statement of Robert D. Hormats

THE OUTLOOK FOR THE DEVELOPING COUNTRY DEBT PROBLEM

Mr. Chairman:

In recent weeks this Committee has received testimony regarding the continued seriousness of the developing country debt situation and its impact on the United States.Against that excellent backdrop,I shall concentrate on the two subjects which are the focus of this hearing: 1)how the debt situation is likely to evolve over coming months, and 2) whether,and how, the US can influence it in a constructive direction.

The basic figures regarding the size of developing country debt, particularly that of Latin America, are well known to this committee.You are also well aware of the combination of adjustment measures by the high debt countries, substantial trade surpluses, new resources from the IMF and the commercial banks,and major reschedulings that in 1982,1983 and 1984 improved the debt outlook of several important developing nations.

These efforts helped to avert an international financial crisis and the collapse of the economies of significant debtor countries. But external adjustment has proved to be quicker and easier than internal adjustment.The later is far more structural and politically difficult.

As the result,the fundamental economic situation has not significantly improved for many debtor nations.And concerns are rising about the future debt outlook.Today, several medium size developing countries,e.g. Bolivia, are in what might be called a state of "suspended default," i.e. they are being kept from actual or "legal" default by the injection of new funds or the unwillingness of creditors to declare them in default (with all the unpleasant legal and other actions that would likely follow).

Major adjustment -- in the form of tighter fiscal and monetary policies, reduced subsidies, market oriented pricing, and a more market related exchange rate policy -- was clearly needed after the excessive build up of debt before mid-1982 and the large trade and domestic imbalances it permitted.And in most high debt countries the need for maintaining adjustment measures continues to be recognized.The recent annoucement by President Alfonsin is the latest evidence of that.Moreover,the pains of adjustment were, to varying degrees, anticipated but even the most resolute adjustors, such as Mexico, probably never expected them to be quite so socially painful.

Many observers pointed out,however, that over time such adjustment,supported by new IMF resources and prudent bank lending,and accompanied by healthy growth in the industrialized countries (particularly the US),would bring about economic progress in high debt countries and eventually alleviate the social stresses resulting from the debt problem.

It now appears that despite important improvements, and some welcome growth in a few of the major debtor countries, new debt problems may be on the horizon.And there is a realization that many manifestations of the old problem have simply not gone away.Unemployment in many debt-burdened countries remains extremely high -- especially in urban areas and among young people.Slow growth and extremely high rates of inflation erode real incomes and combine to undermine the middle classes -- historically a stabilizing political force in many nations.Development projects have for the most part been put on hold or cancelled altogether.Commodity prices, so crucial to the least developed countries in Africa and still to a number of Latin American and Caribbean nations, have not rallied as might be expected in light of recovery in the US and other industrialized nations.And pressures for new stimulus --- although impossible for many countries because of foreign exchange constraints -- are emerging as the social costs of prolonged austerity weigh heavily on governments.

Added to these problems is the concern in some quarters that the rate of growth in the US -- which has been a powerful, indeed decisive, factor in improving the trade position of many Latin American countries -- may remain weak or falter. While it would be a mistake to assume that the weakness of the last several months necessarily forshadows a recession -- because the more expansionary Federal Reserve policy which began last fall, and the attendant drop in interest rates, could well enable growth to rebound -- these poor figures at least serve to draw attention the possible consequences of a serious US economic slowdown for high debt countries and must force us to come to grips with that possibility. Even late last year, with strong US growth the balance of trade figures of some large debtors began to weaken and commodity prices were soft.The exports of Argentina, Brazil,Chile and Mexico are all down relative to the same period last year while those of Columbia, Ecuador, Peru and Venezuela are up.But a sustained period of very weak growth in the US and other industrialized countries would almost certainly weaken exports of all of these countries.

A second added concern is that new measures by the US and other industrialized countries to protect their economies against foreign competition will restrict export opportunities for high debt countries and thereby reduce their ability and willingness to repay their debts.A third is that new resource flows from abroad -- by banks and other sources -- will not grow as fast as needed to overcome foreign exchange constraints to growth and investment.

THE PERIOD AHEAD

There are three broad types of scenarios that -- howvere unconfortable to contemplate some are -- must be considered in our contingency planning.

One, slow but steady progress.This scenario is the most likely of the three assuming:a continued recognition in high debt countries that policy improvements remain necessary,reasonable growth (3% or above) and market access in industrialized countries, and adequate new financial flows to debtors.Under this scenario, adjustment will probably continue in the major debtor countries and serious problems can probably be either avoided or managed in the smaller ones. There will be a number of negotiations of new IMF stabilization agreements,and modifications in a several current rescheduling agreements with the banks, but most countries will maintain trade surpluses sufficient gradully to reduce the debt/export and debt/GNP ratios and achieve enough domestic growth to maintain social stability.

Two,this scenario -- which attains a higher probability the greater the departure from the above assumptions -- involves slower adjustment by some larger debtors and attempts by some smaller ones to negotiate partial moratoria.Under this scenario many of the larger debtors would seek to utilize a higher portion of their foreign exchange for domestic needs.Most major debtors would,however, continue to try to maintain reasonable repayment schedules and have some type of adjustment understanding with the IMF; but most would ask for important modifications in terms.A few countries -- mainly those now in a state of suspended default -- might declare themselves unable to repay their debts on the basis of timetables established under earlier rescheduling arrangements or anything close to them; they might also institute domestic policies that would be unable to meet the terms of even the most flexible type of IMF adjustment program. In such circumstances some might well indicate to their creditors that considerations of domestic political stability required them to channel resources to domestic social development needs and that they would pay no more than x millions of dollars per year in interest;they might well ask their creditors to acommodate them by agreeing to or acquiescing in something like a temporary,partial moratorium involving a combination of debt write downs or more generous reschedulings.

Scenario three, which takes on a higher probability if the industrial economies experience a deep recession or resort to major protectionist actions, would involve a general internal economic decline in many debtor countries and in the international debt situation.In this scenario, many debtor countries might well seek far more favorable rescheduling terms but try to keep current on them; others might ask for agreement on partial moratoria, and still others might unilaterally limit servicing their debt -- simply allowing arrears to pile up -- and make little or no effort to reach an understanding regarding stabilization with the IMF.

There is also the related question of political stability in debtor countries.It is, of course, difficult to predict the political consequences of prolonged austerity for individual countries. What is clear, however, is that the weakening of middle classes in many debtor countries and high unemployment threaten social stability.For the new leader of Brazil,and its elected congress,the task of agreeing on a sound stabilization program becomes more difficult if growth in the world declines.For President Alfonsin -- trying to reestablish democracy -- the task is far more difficult as the result of the debt situation.For many other countries,problems of crime, resort to drug exports,major emigration pressures are growing.And for several the possibility of serious political polarization -- with the potential for politics to lurch between right and left would grow if the debt problem worsens.

Some of these scenarios may be unpleasant to contemplate, and indeed harmful to debtors and creditors alike.But in the interest of fulfilling tnis committe's request to describe possible future developments and ways of identifying constructive actions for the US, such scenarios need to be at least laid out so that disasterous problems can be avoided.

WHAT CAN BE DONE?

Let me now discuss several different kinds of approaches to the debt problem.These take acount of -- and attempt to take advantage of -- three of what I believe to be fundamental changes in the international economic environment in recent years.I discuss these first because an understanding of them is useful in deciding on what further measures are needed in order to cope with the debt situation.

First, around the turn of the decade the major industrialized nations -- fed up with the social and economic costs of high inflation -- shifted to an anti-inflationary strategy.During the earlier period inflation was high, real interest rates low, and borrowing apparently "cheap" while the holding of interest bearing securities was not especialy attractive.

The dominant force in this policy shift was the tight money policy of the US Fed, and its refusal to monetize the large US federal budget deficit. Other countries manifest their anti-inflation policies in the form of tight monetary policy, tight fiscal policy, or both.

One consequence of this world economic "sea change" was sharply higher interest rates and, for a time, sharply lower growth. It also meant that traditional "real" hedges against inflation (gold, silver, land, etc) became less desirable to hold and financial asssets , with their now higher rates of return, became more desirable. Because over two-thirds of financial assets are denominated in dollars, this shift in asset preferences itself meant a higher demand for the dollar thus helping to push up its foreign exchange value.

The net result was that those who had borrowed in dollars in short term or floating rate financial instruments -- i.e. most of Latin America -- incurred a double increase in their debt burden;at the same time, they were hurt by a weakeness in foreign markets for their products.A more balanced borrowing strategy -- gearing currency repayment obligations closer to export earnings,providing for ways of smoothing out interest payments, and ensuring productive use of borrowed funds however "cheap" -- would have reduced the intensity of the problem.This lesson can help guide future borrowing strategy, as discussed below.

Second, there are growing differences among developing countries in terms of economic circumstances, quality of policies, and ability to adjust to the debt problem. The debt problems of most African countries are, for instance, largely the result of borrowings from official sources, whereas those of Latin America stem from heavy commercial borrowing.Within Latin America some countries, e.g. Columbia, did not engage in excessive borrowing or make major policy mistakes and therefore retained their creditworthiness.And some, like Mexico, have adjusted more rapidly than others.

East Asian countries, except for the Philippines, have managed to avoid the worst aspects of the debt problem because of the basic flexibility of their economies, maintenance of relatively market related exchange rates,and avoidance of major price distortions or subsidies. They have also maintained a climate hospitable to domestic and foreign investment. Korea, for example,faced many of the same difficulties as Latin America, but managed to adjust earlier and with less pain.

The quality of internal policies is, therefore, a critical variable in a countries susceptibility to and ability to withstand international economic problems.As described later, these differences are a strength developing countries can take advantage of.

Third, the locus of world savings has shifted among and within countries.In the 1970s OPEC nations were the world´s big savers.And while today they are still important, it is now Japan which is the world´s largest saver, with Germany and a few other European countries also assuming greater importance.

Within the industrialized countries there also has been a major change as pension funds and other institutional investors assume an ever larger role relative to banks as intermediaries of private savings.They are the largest participants in stock and bond markets and their investable funds could support productive investment in developing countries.

I now turn to the areas in which steps that could be taken to alleviate some of the pressures of adjustment and thereby improve prospects for its continuation and to establish the basis for sustained growth in debtor nations.

Over arching all of what I suggest below is domestic economic policy in the US and other industrialized countries,and continued resolute adjustment efforts in debtor nations.US policy, because this country is by far the largest market for most high debt countries, is critical.The Federal Reserve Board today, probably more than any time in its history, is actively taking foreign considerations into account in making policy decisions.It has evidenced strong recognition of the consequences for the US economy and financial system if a major drop in US economic growth or a sharp increase in interest rates were to cause a sharp deterioration in the developing country debt problem.This recognition and willingness to act is an important source of optimism about the debt situation.

Let me now discuss a series of specific measures.

First, the major constraint on many debtor nations is foreign exchange.One possibility to help alleviate this is for the EX-IM bank to establish loan guarantee facilities to guarantee new private export credits, with the commercial banks contributing(and earning interest on) say 25% and the EX-IM using its own guarantee authority for the remaining 75%.Other creditor countries would be asked to establish similar facilities.A facility would be established for each country pursuing a sound stabilization program.Each would be administered by the EX-IM Bank but decisions would be made based on consultations with authorities in the debtor country;the facility would only guarantee export credits for specific debtor country programs which improved industrial and agricultural productivity.

Along the same line, the World Bank's management should be encouraged to pursue the idea of a new "Bank's Bank". This would have a higher gearing ratio than the Bank's charter currently permits (i.e. one dollar callable for every dollar of lending guaranteed).This new Bank, with a higher ratio,could participate actively in cofinancing programs by,for example, guaranteeing later year maturities.It could also lend directly to soften terms to poorer nations in debt difficulty.

Another varient is the positive involvement of the International Finance Agency (the World Bank's window to support the private sector) in joint underwriting of borrowings or equity issues by private institutions in developing countries.Recently, the IFC and Goldman Sachs were co-lead managers in a $50 million floating rate issue by BLADEX -- an export financing bank owned largely by Latin American and foreign private banks and Latin

American central banks.This was the IFC's first co-lead managership and the first Latin American capital market borrowing in three years.More such co-managed borrowings, or joint stock underwritings, for worthy companies in developing countries are possible.They have the major advantage of diversification by tapping the institutional lender market noted above.

A second group of measures relates to rescheduling and new borrowing policies. Mexico's multiyear rescheduling, with improved terms was helpful as a reward to it and an encouragement to others. A major step forward would be to negotiate -- on a case by case basis -- similar terms with a wider range of deserving countries.

In addition,it would be desirable for each debtor country to fashion a borrowing strategy which, through direct borrowing or currency "swaps" (swapping say a dollar obligation for a DM obligation,with appropriate adjusment in interest rates), to maintain currency repaymnt obligations roughly equivalent to its foreign exchange earnings.And some sort of interest payment smoothing arragements should be incorporated into new borrowing agreements (e,g. capitalization of interest over a certain level or arrangements to defer payments when rates rise and repay more quickly if interest rates decline below an agreed point).While these features would raise accounting problems if incorporated into existing loans, that option should be considered as an alternative by babk examiners and accountants to help reduce the impact of any future rise in interest rates;they can be agreed more easily on new loans.

Similarly, developing countries today could make far greater use of the forward and options markets to hedge against sharp currency movements.Many such techniques have been used very effectively by large corporations to reduce risk exposure, and there is no reason that governments cannot do likewise.

A third area relates to trade.There is a surprising reluctance among many developing countries to agree to a new round of multilateral trade negotiations. Some want assurances that the issue of graduation will not be raised; some argue that the provisions of the Tokyo Round must be fully implemented first.Some want preagreement on certain cuts in restrictions on textiles or other goods.

Yet, tragically, the longer they wait the more industrialized and developing countries alike impose new import restrictions which limit trade. Paradoxically,it is the developing countries -- which have most to gain from a more open trading system and most to lose if it continues to deteriorate, who seem least willing to support the concept of a new round. They will need soon to reassess their position. There is no perfect time to begin negotiations, but they less than most can afford to stall the process.

Industrialoized countries for their part need to recognize that many trade barriers put heavy burdens on countries already hsving great difficulty in servicing their debt.There needs to be greater attention given to the vulnerabilities of our own financial system, which is vital to our domestic growth, when new import barriers are imposed.

The forth area is traditional concessional assistsnce.For the poorer countries there is no substitute for soft loans. It is somewhat surprising that we as a nation can respond so generously to the enormous human tragedy of African hunger and not to the crying need for longer term assistance to support development in these extremely poor countries. Somehow we miss the connection between the desperate problems of today and the inadequate amounts and, it must be said, often ineffective use by recipients,of money for the very poor countries.IDA, US AID, and the Inter American, Asian and African Development Banks all have a major role to play in addressing the debt problem. Despite our own budgetary constraints, now is hardly the time to cut back on support for them.

In addition,it would be desirable to encourage the World Bank to lend to improve existing projects, even if it earlier played no role in them.Sectoral adjustment policies ,to improve production incentives, phase down subsidies, and improve investment incentives should also remain an important component of new lending.Andthis should achieve full US support.

A fifth area concerns the much neglected private sector.In many countries the private sector has been seriously harmed by the debt situation.Credit has been limited,devaluation has increased the local currency cost of repurchasing dollars with which to repay foreign bprrowing, and slow growth has cut profits.Moreover private reschedulings normally follow public debt reschedulings creating major uncertainty for private firms and their creditors.

It is largely up to the debtor countries themselves to recognize the importance of a dynamic private sector to their economies and to ensure that it does not suffer from excessive resource constraints.But outside assistance from the IFC and the IADB, through its new facility for this purpose, can prove useful.

Moreover, much can be done to strengthen domestic capital and equity markets so that the private sector can have access to savings.It is widely recognized that high debt countries need to increase their savings rates and use savings more efficiently. A well functioning capital and equity market can help in this regard.Again the IFC has a major role to play.

Finally, the climate for foreign investment does not appear very attractive in many high debt countries.Despite many pronouncements that new investment is encouraged, regulations and bureaucratic attitudes appear to the contrary in many nations.Such attitudes mean that the imbalance between foreign debt and foreign equity flows will continue, and the employment and technology benefits of new direct investment will go elsewhere in the world.The US Overseas Private Investment Corporation can play a major role in encouraging private investment in high debt countries,as it has in the past.But in the final analysis it is the debtor countries themselves that must prove more encouraging.

The last area addresses what the developing countries can do together to overcome the debt problem.Early last year the Quito Declaration of Latin and Caribbean leaders underscored ways to increasing trade, technolgy flows, and industrial cooperation among nations of the region.These steps might well be supplemented by a discussion, parhaps jointly sponsered by the World Bank, IMF,IADB and ADB to discuss the experiences of each debtor nation with its adjustment policy. This would be much like an OECD Economic Policy Committee discussion -- it would not issue a communique but give ministers and officials of individual debtor countries the opportunity to have their policies privately commented upon by others who have been through, are going through, or have avoided the need for adjustment.

These measures do not add up to a panacea, but they together can be of significant help to debtor countries in dealing with what continues to be a very serious problem.I believe it particularly important that we address the debt question not with a sense of panic but with a sense of urgency based on its seriousness and its importance to the US.

Representative OBEY. Thank you. Ms. Lissakers.

STATEMENT OF KARIN LISSAKERS, FORMER DEPUTY DIRECTOR, POLICY PLANNING, THE STATE DEPARTMENT

Ms. LISSAKERS. Thank you, Mr. Chairman. I would like to focus my remarks on the relationship between the debtor countries and the commercial banks which are their major creditors, and put that relationship in the context of the broader political and economic environment which the earlier witnesses have discussed.

As the other witnesses have pointed out, we have an extremely delicate situation. Despite the rather remarkable performance of a number of the debtor countries, and some very favorable economic trends, external economic trends, most notably the decline in interest rates, the situation, I believe, is extremely fragile. I think there's good reason to doubt that it will hold for any extended period of time.

I'm one of those people that Walter Wriston refers to with considerable contempt as a Cassandra on the international financial situation. I think he's forgotten that Cassandra was right.

In my opinion, the current situation, the current debt restructuring approach does not constitute a solution to the debt crisis. I have some support in this opinion from other bankers who are now beginning to say, even in public, that they doubt that the current situation is sustainable. Some American regional bankers point out that the debt burden is still crushing and that this is really just the very beginning of a very long process, indeed, of working out and holding the situation together.

And the European bankers are, in general—I've just come from a 2-week trip, research trip for a book I'm working on on banking, and I've talked to a number of bankers, both on the Continent and in Britain. I must say that they generally express a good deal more pessimism in conversations about the situation and the outlook than do the U.S. money center banks.

A German banker said to me, whereas U.S. banks express cautious optimism, we are cautious, but not optimistic. And the central bankers I spoke to also were rather pessimistic.

Now as the other witnesses have pointed out, the economic condition, the economic performance of a number of the debtor countries, although by no means all, has been rather better than one would have expected. And the treatment that they've gotten from the banks in the so-called phase 2 of that restructuring has been much more reasonable than it was in phase 1. I think that Congress can take considerable credit for that by putting the heat on through the International Lending Supervision Act of 1983 which, for example, made it not very attractive for banks to charge up-front fees, rescheduling fees, because of the change in the accounting rules. And the additional disclosure requirements and the pressures that the Congress put on the regulators to be much tougher on the international lending side, I think forced the banks to take a new look at what they were doing, as did the conditions of the debtor countries.

But these regulatory changes, as I will point out later on, also have long-term implications for banks' attitudes toward continued or resumed lending to these countries.

The bankers have strengthened their own balance sheets, partly as a result of pressure from the regulators. They have built up loan-loss reserves. They have written down some loans, although in the U.S. case, it's pretty modest. The most significant improvement in the U.S. banks' situation, I think, is the buildup of capital. The new banks, the large money center banks are now, for the first time, operating under a firm minimum capital-asset ratio requirement. And there is, in fact, a differential requirement for banks that appear to be somewhat, to have weaker balance sheets than others, are subject to higher capital-asset ratio requirements than the strong banks with stronger balance sheets.

The debtor countries, of course, have performed well on the external side, although, as Bob Hormats pointed out, the internal situation is still dicey and the price that's been paid is enormously high in terms of people's declining standard of living. And the price in terms of the long-term economic strength of these countries may also—if these external strains continue—be much higher than they should be.

The question whether the current situation is sustainable and, in some ways, constitutes a solution is partly a question of definition. Certainly, it's possible to jigger the numbers, barring some disaster on interest rates or growth rates in the industrial countries, to show, to project a situation for the next 4 or 5 years maybe where these countries—at least the big debtors—can sort of limp along and they can continue to service, can limp along and can maintain debt service payments with minor disruptions and with a very small external flow of capital. And they can have some growth, some marginal improvements in living standards.

And that, from the banks' view, is probably acceptable. I mean, it protects their earnings stream and it protects their principal, at least in theory.

But, as a matter of U.S. public policy, I don't think that this should be acceptable—first, because it's very risky. As everyone says, if there's an adverse change in one of these factors, in interest rates or growth rates, the whole program goes down the drain. And second of all, it condemns these countries to rates of growth that mean perpetuation of an extremely high unemployment situation, a very low standard of living for a large proportion of the population, and a not very healthy economic relationship with us.

I mean, it ultimately plays back to our own economic growth.

So far, the real cost of the debt crisis has been shifted from the banking system to the debtor countries and to our own exporters and manufacturing industries. If one expects to continue the current arrangement, then that cost is going to continue to fall primarily on those groups.

I think that the underlying bargain of the current debt arrangement is not going to be sustainable for other reasons. The basic bargain that was struck in the debt renegotiations was that the debtor countries would take strong austerity measures and continue to pay their external debts, or at least make the interest payments to the banks and, in turn, the implicit promise from the banking system was that you do this for a couple of years and then you can come back to the market and you can resume borrowing, not at the same level as before, but there will be a significant net inflow of funds from the commercial credit markets to these countries. And then you can resume growth and there will be a much more normal and positive situation.

The debtors have so far, with some exceptions, fulfilled their part of the bargain, believe they have anyway.

But the banks—I think the banks are not going to hold up their end of the bargain over the long term. That is to say, I doubt very much that they will resume lending anywhere near a level that the debtor countries expect from the banking system, not only because the outlook for the debtor countries is so shakey, but because fundamental changes are taking place in the structure of the international banking system and the international capital markets, in general, that profoundly affect banks' interest and attitude toward international lending.

Among the changes that have taken place, first of all, are the regulatory changes, the toughening of rules that I mentioned before: the capital asset ratio requirements, the requirement that banks improve the quality of their balance sheet; that is, they eliminate loans to weak borrowers, doubtful loans. These all put a real damper on the banks' interest in lending, increasing their lending to these countries.

When they lend now, when you talk to them, they say, first of all, we're not interested in asset growth; that is, loan growth, per se. We're interested in increasing the return on equity, increasing the return on assets. We're interested in low-risk lending. Insofar as we do any lending, we want to lend to prime risks in the industrial countries. We don't want to lend to high-risk places.

Also, the disclosure requirement makes the banks, U.S. banks, who are subject to much greater disclosure requirements than European banks, very nervous about any apparent increase in exposure particularly to Latin America. When they're trying to go to the stock market or to the capital markets to raise capital, they're very concerned about what the reaction would be if there's an apparent increase, other than under a forced lending program, where they apparently have no choice.

So the attitude toward an increase in voluntary lending—and it's true for the European banks I've spoken to as well—is very negative. And a number of regional bankers simply say, look, we're getting out of the business. We're not interested in doing any syndicated lending business. We'll do some trade finance. We may do some project finance over the long term to support our local client, our home client interest in these countries, but we're not going to be big players any more.

And there is this segmentation of the market which leaves the big banks with the biggest chunk of this future business, potentially. But they are also the banks in the least strong position to increase lending because they have the largest exposures relative to capital. And until you get a significant reduction in their exposure to these countries relative to capital—which is not going to happen as long as these countries aren't amortizing the debt and, in fact, you have some forced lending which actually increases outstanding—there is very little room for those banks to do any additional lending on a voluntary basis.

And one can see this in the numbers. The U.S. banks, since 1982, have virtually not increased their exposure to the non-OPEC developing countries at all. What you have is some increase under forced lending programs in a couple of the big debtors and an offsetting decrease of exposures to other developing countries.

As far as I can see, it's an absolute deliberate decision to keep the overall exposure constant. Even Citibank, which, historically, has been the most aggressive international lender and the most upbeat about the outlook for the debt situation, points out, emphasizes in its 1984 annual report that it has not increased its international exposure since 1982.

And I don't see anything in the outlook that would dramatically change that bank attitude; on the contrary, the fact that the changes that would be—deregulation here in the United States and deregulation that's taking place in the financial markets in Europe as well, the opening of opportunities for foreign banks in Britain and in Germany, to an extent also in Japan and in Scandinavia, and the warfare that one can expect and the takeover battles that one can expect as we move to interstate and probably national banking in the United States, means that banks' attention and efforts and resources are going to be focused here, not on Brazil. They will do the bare minimum that is required to keep these countries afloat, and not much more.

I should also point out in passing that the statistics turn out to be even more horrendous than one had expected. It hasn't been very widely noted that the BIS has increased the scope, the breadth of its data gathering by finally getting reports directly from the major offshore money center, like the Cayman Islands and Hong Kong and Singapore. And in the process they flushed out another $70 billion in commercial bank claims on the non-OPEC developing countries. It turns out that Brazil, for example, owes $15 billion more than anybody had realized on the basis of the old BIS statistics.

These numbers just came out in February 1985. So that at least the academic exercises that looked at debt-to-export ratios and debt-to-GNP ratios and so on are already overtaken by this new data base. I mean, they understate the problem.

But I think, as I say, the most significant change is really in the structure of the banking industry and the new regulations that are putting pressures on banks to do other kinds of business even over the medium term, even if there should be a significant improvement in the outlook for these debtor countries.

Given that assumption, and I think at least the strong possibility that one of favorable external economic conditions, interest rates or growth rates in the industrial countries will take an adverse turn at some point, I think we at least have to contemplate and prepare for the possibility that countries are not going to be able to maintain their interest payments.

I mean, really, we're not talking about amortization payments because there virtually aren't any, except some short-term debt. The cash-flow strain on these countries is the interest payments. And I think we have to prepare now rather than have a continuing series of disruptions in payments, even though countries, I don't think, are inclined to repudiate the debt. I mean, we've seen that most debtors are willing to go through a lot of grief and pain in order to maintain their interest payments. But there comes a point when you simply can't do it any more.

I think one has to be prepared now, and the Government has to be prepared now, to consider an alternative path that would ease the cash-flow strain on these countries. And one possibility, it seems to me, is what Preston Martin suggested, apparently to the chairman's dismay, the other day, which is a cap on interest rates and either forgiveness of interest payments above the cap or a deferral and capitalization; that is, making the deferred interest portion of the interest payments part of outstanding principal.

It's not something the banks would be very happy to do. But one does imagine that if the choice is that or simply having to report your whole international loan portfolio as a nonaccruing asset, that the choice between some interest payments and no interest payments or constantly disrupted interest payments, I should think, would be a fairly easy one.

And as I noted before, the banks are generally in a stronger position. Earnings are up because of the falling interest rates. Their interest margins improve. The bank stocks have been rising significantly, even the money center stocks. The stock market is fairly bullish on big bank stocks, if one looks at some of the newsletters from the various stock analyst outfits.

I think that such a step—capping interest payments—which would require considerable pressure from the Fed and from the Comptroller's Office, and maybe from Congress, I think should at least be contemplated.

The Europeans I've talked to, both central bankers and commercial bankers, are certainly willing to discuss such a possibility. Many, in fact, see it as quite a likely step. U.S. banks are still extremely reluctant, at least in public, to discuss such a step, especially the large money center banks.

I will end my comments there, except to say that I subscribe to many of the other suggestions that Bob Hormats had, for example. There are some things—I mean, the bankers are now saying, look, the public sector is going to have to do much more—the IMF, the World Bank, the U.S. Government, official aid donors, and so on, are going to have to assume the burden. We're not going to do it any more.

Certainly, I think that there are some more things that could be done. For example, temporarily eliminating or reducing the counterpart fund requirement for World Bank and the other development bank loans. I gather that the U.S. position has been very negative on this and it means that a lot of really desperately needed development projects are now sitting on the shelf, not because the development banks don't have the money, but because the debtor government is having to cancel its provision of counterpart funds because it is trying to reduce Government expenditures. And a number of other steps. But I certainly don't see the possibility of any increase in IMF or World Bank resources large enough to cover, nor do I think necessarily that is the best use of official funds—that is, to enable countries to make their interest payments to the banks. Thank you.

[The prepared statement of Ms. Lissakers follows:]

PREPARED STATEMENT OF KARIN LISSAKERS

Mr. Chairman, Members of the Committee, I appreciate this opportunity to testify before you concerning the international debt crisis.

Previous witnesses have discussed the importannce of economic ties between the US and heavily indebted Third World countries. And other members of this panel have given you some indication of the effects various economic scenarios would have on those ties.

I would like to concentrate my remarks on the relationship between the debtor countries and the private commercial banks that are their major creditors. I will explain why I believe the relationship will be deeply troubled for some time to come -- even under reasonably favorable economic conditions -- and why I have doubts about the viability of the current approach to the international debt crisis.

I am one of those Cassandras Walter Wriston refers to so contemptuously -- someone should remind Mr. Wriston that Cassandra was right -- who expressed concern about the level of bank lending to sovereign countries in the 1970's and who now doubts that the current approach to the debt crisis constitutes a long term solution to the debt problem.

Some bankers share my doubts. As Frederick Heldring, Deputy Chairman of the Philadelphia National Bank told an international monetary conference last November, "To use a sports metaphor, we believe that at best we are at the beginning of the third inning of a long ball game that may extend as long as 25 years in some cases and 15 years in most cases. We agree that a great deal was accomplished in the first two innings...However, the debt is still a crushing burden on most countries in Latin America.

And I just returned from a trip to Europe where bankers and regulators also expressed considerable pessimism about the outlook. A German banker told me: "We may not have seen the full extent of problems with these countries. Whereas some U.S. banks express cautious optimism, we are cautious but not optimistic."

An official at the German Bundesbank told me, "The outlook for Phase III [i.e. the resumption of normal credit market access for debtors] is not good at all. We have to get debt service in acceptable ratio to GNP. Even Mexico can't go on like this for the next decade."

Certainly, the situation looks far better than it did a year and a half ago: bankers have curbed their greed (in large part thanks to the pressure put on them by Congress during the debate on the last IMF quota increase and to the new rules enacted in the International Banking Supervision Act of 1983). The banks have offered troubled debtors better restructuring terms than in the first round of debt renegotiations. Maturities and grace periods are longer, several years' due debts are rescheduled at once.

spreads are narrower, fees have been reduced or eliminated. The bulge of excess short term loans requiring immediate amortization has been smoothed through rescheduling.

Bank regulators have taken a somewhat tougher line both here and in Europe and have forced the banks to accumulate capital, build up loan loss reserves, write down some foreign loans and more accurately report non-accruals. The banking system is stronger as a result. For the 35 large money center and regional banks Salomon Brothers follows closely, primary capital as a per cent of total assets increased from 4.5% in 1980 to 6.3% in 1984, meaning an addition of $33 billion dollars in capital. Loan loss reserves as a per cent of total loans went from less than one per cent in 1980 to 1.25% in 1984, or from $4.5 billion to $9.2 billion -- not dazzling, but at least moving in the right direction. At the same time, for a sub-group of twenty banks with large foreign operations, international loan chargeoffs rose from $208 million in 1980 to $1 billion in 1984 while international non-performing assets rose from $1.1 billion to $10 billion in the period. The total loan exposure to non-oil developing countries for all U.S. banks is $106 billion (September 1984).

Debtor countries have endured several years of deep recession and in some cases, most notably Brazil and Mexico, have produced surprisingly large trade surpluses, thanks largely to our enormous trade deficit, which enabled them to meet debt servicing payments without new loans. (Though there were large forced jumbo's for both in the last quarter of 1983 that carried over into 1984.) There was some accumulation of reserves. All the major Latin American debtors except Venezuela had some growth this year, although not at the levels necessary for employment to keep pace with population growth. It should be added that the situation for smaller Latin debtors, not to mention Africa, is much bleaker. The banks have been less accomodating on reschedulings and new money and a number of the smaller countries have made no or only sporadic interest payments in the last year.

The recent drop in interest rates helps everybody. Each 100 basis point fall in dollar rates saves Argentina $500 million in interest payments per year, saves Brazil $800 million, Mexico $800 million and Venezuela $310 million. The weakness in oil prices is obviously a mixed blessing.

Despite all this good news there are reasons to doubt that we now have a "solution" to the debt problem, unless by solution one means that the major debtors can limp through the next couple of years without major debt servicing disruptions and with perhaps a little growth.

From the banks' point of view, that may well be satisfactory. Their primary objective is to protect their existing loan exposures (without any significant increase) and the income stream from those loans.

But as a matter of U.S. public policy, such an an outcome is not acceptable. It is in both our own and the debtor countries' interest that we try to create the conditions for real economic recovery in which the standard of living in debtor countries steadily improves and they provide growing markets as well as products for the industrial countries.

The existing bargain between debtor countries and creditor banks will not create these conditions.

The basic bargain struck in the debt negotiations to date has been: economic austerity and faithful debt servicing by debtors in return for the promise by the banks, implicit if not explicit, that "normal" lending would shortly resume. Underlying Mexico and Brazil's acceptance of deep recession at home and a net transfer of resources to the banks to meet heavy interest payments was the assumption that these conditions were temporary and would lead back to the market and to "normal" borrowing, that is, a net transfer of capital from the banks to the debtors. This bargain may begin to unravel as the resumption of "normal" borrowing seems more remote than ever.

Most of the major debtors have fulfilled their part of the bargain, beyond expectations. But their political and economic capacity to do so for another couple of years is in doubt. The successful trade effort of Brazil and Mexico in particular depended first on a drastic slashing of imports and second on the extraordinary appetite for imports in the U.S. Morgan Guaranty estimates that 85% of the increase in Latin American exports went to the U.S. But the weakening dollar and slowing economy is likely to cut our trade deficit without any assurance that the rest of the OECD, whose weaker recovery depended in part on exporting to the US, will take up the slack in demand for LDC goods.

Furthermore, economic recovery in the debtor countries immediately generates demand for imports necessary for domestic industry to expand production--imports the countries can't afford while they have to meet heavy interest payments on their debt and receive very little capital from abroad. The BIS estimates that the net interest payments (net of interest earned on reserves) by the non-OPEC Latin American countries amounted to nearly $30 billion in 1984.

Any attempt by these countries to grow rapidly without new money inflows immediately bumps up against the constraints of their foreign debt and the need to meet interest payments. The New York Times pointed to the dilemma with a recent rather ironic headline: "Mexico Encounters Problem of Growth" (June 10, 1985). Debt servicing in the absence of new borrowing requires that Mexico run large trade surpluses. But as the Times points out "As soon as the economy showed signs of life, imports soared," by 38%, exports dropped and inflation picked up.

Also worrisome is the low level of domestic investment in these countries and the continued high rate of inflation in most of Latin America which hurts the competitiveness of their goods abraod.

Even if these countries manage to hold up their end of the bargain for another year or two, it will become increasingly apparent that the banks are not about to hold up theirs, that the resumption of normal lending seems more remote than ever. The reasons have partly to do with a continued uncertain economic outlook for debtors but more importantly perhaps with structural changes in the banking system.

A resumption of significant voluntary lending to the major debtors cannot, will not, should not resume until two conditions are met: one, that the debt to GNP ratios of the debtors improve, and two, that the ratios of troubled ldc loans to capital of the major lending banks improve.

The debt to export ratios of some debtors has improved significantly, but it would take only a minor economic downturn in the OECD to reverse that improvement. Therefore, debt/GNP is a more meaningful measure of a country's debt carrying capacity over time.

Under the current debt arrangement, the big debtors have gone into recession, i.e. GNP has declined until last year, while indebtedness has increased through forced lending and IMF drawings. And there has of course been little amortization. Another little noted fact is that the BIS improved and expanded its data gathering after 1983 by adding data from several more European countries and from off-shore bank havens like the Bahamas and Hong Kong. In the process it flushed out an additional $70 billion in bank claims on the non-OPEC developing countries that had heretofore gone unreported. Claims on Asia jumped more than $30 billion while claims on Latin America turned out to be $34 billion higher than was thought when the debt crisis started. It turned out that Brazil owed $72.9 billion to foreign banks on December 1983, not $57.4 billion as the old numbers showed. Since the BIS did not report this new data until February 1985, any calculations about relative debt burdens done before then is likely to seriously understate the problem.

Debt/GNP ratios are therefore not likely to improve dramatically in the next few years.

The combination of tougher banking supervision and new challenges and opportunities for banks in the industrial country markets is reinforcing the effect of the debt crisis on bank attitudes toward lending to developing countries.

As already noted, American and European banks have come under strong pressure from regulators to strengthen their balance sheets . This means improving capital/asset ratios, reducing the proportion of questionable loans in the portfolio, writing down doubtful loans, reporting non-accruals. US banks have also been forced to publicly disclose much more information about their exposure to individual troubled borrowers. Any bank trying to raise capital is likely to be extremely cautious about increasing exposure to troubled debtors that will have to be reported to shareholders.

The emphasis at most banks today is on growth of profits, not assets, and on increasing the return on equity and on assets, not increasing the volume of loans on the books. Non-interest income is expected to grow more rapidly than interest income for the bigger banks, despite a more favorable spread between interest earnings and funding costs as rates fall.

When banks do lend, it is to prime risks here or in other industrial countries. A few Asian borrowers are still in demand, and the banks seem to have forgotten their concerns about Eastern Europe and are now lending to the region although not Poland. But US banks seem determined to hold their foreign exposure constant, excluding Western Europe. Any forced increase in exposure to one developing country is apparently off-set by reducing loans to other ldc's.

U.S. bank loans to foreign countries outside Western Europe were only 0.5% higher at the end of September 1984 than in September 1982. While loans outstanding to Latin

America had increased by 7.5% because of forced lending, loans outstanding to all other regions had declined. Some regional banks are said to be disengaging from the international markets, having written down or sold off much of their foreign loan portfolio. But even the big money center banks are hanging back. An increase in the nine money center banks' exposure to Mexico and Brazil has apparently been off-set by a reduction in claims on Korea and Taiwan while claims on the eight other biggest LDC borrowers remain virtually unchanged.

Citibank, historically the most agressively international of US banks, points out in its 1984 annual report that "Citicorp's total worldwide cross-border exposure has remained essentially unchanged since 1982".. In 1982, domestic operations accounted for 27% of Citicorps pre-tax income --only slightly more than Brazil's contribution. In 1984, domestic operations were over 40% of the total. Some money center banks are cutting their international staffs and closing foreign rep offices. Wells Fargo, a large regional with a substantial foreign loan portfolio recently announced that it is going to shut down its London office.

Liberalization of financial markets in the industrial countries has given the banks new interests and concerns. U.S. regionals are girding for the take-over battle that is ensuing with the advent of regional, if not yet national, interstate banking while the money center banks try to find a way in through the back door. Meanwhile Australia, Norway, Sweden and Portugal are opening the front door to foreign banks for the first time while Canada, Britain, Germany and Japan have announced measures that will substantially broaden the range of domestic banking activities open to foreign banks on their turf.

All of this suggests that the slow-down in ldc lending may be more than temporary. Certainly the smaller banks seem likely to reduce their international participation over the forseeable future. The regional bankers I've talked to say they would do some short term trade finance but stricly to support the business of a local US client. The foreign bankers I spoke with last month talked about the possibility of new term lending to Latin America in the 1990's.

Some US money center bankers still talk bravely in public about a quick return to voluntary lending, to Mexico, for example. In private, they are not so sure. And the fact is that precisely these banks are in no position to lend more money to the Mexicos or the Brazils because their existing exposure to these countries relative to capital still far exceeds any reasonable prudent lending limit. Based on the 1984 annual reports, the claims on Mexico, Brazil and Venezuela are 152% of equity, 143%, and 139% for Bank of America, Chemical and Chase Manhattan Bank, respectively. The claims of Manufacturers Hannover, Citibank and Morgan Guaranty Trust Co. on Mexico, Brazil and Argentina are 218%, 143% and 126% of shareholders equity, respectively.

One perverse effect of the debt restructuring has been to increase the concentration of exposure to the biggest debtors by the banks already most exposed. As smaller banks have refused to participate in new lending, for example the jumbo to Argentina, the bigger banks have had to increase their commitments to come \up with the requisite total. And as the numbers show, the big banks have reduced their exposure to stronger debtors like Korea and Taiwan in order to make more loans to Mexico and Brazil. In addition, a large proportion of the private sector loans in these countries have been replaced by loans to the central governments in the restructuring, thus further increasing the concentration of loans to a single borrower.

The banks' reluctance to lend is correct: the large banks are in no position to increase their exposures and the big debtors are in no condition to carry more debt.

But if substantial new money is not going to be forthcoming from the banks anytime soon -- and it is hard to see where else it might come from -- then the present debt bargain is not viable.

My expectation is that debtors will become increasingly reluctant to continue paying out tens of billions of dollars in interest with little new money coming in, if this means deferring growth indefinitely.

I am not predicting wide-spread debt repudiation. These countries have been willing to suffer a lot of pain to stay in the good graces of the international financial community. Bolivia and Peru have stopped paying because their economies are a shambles and they simply can't. But even revolutionary Nicaragua has scrupulously played by the rules in managing its external debt. And now President Alfonsin is gambling his political future and perhaps that of Argentine democracy in a bold and courageous effort to pull his country out of its economic tailspin while meeting its external financial obligations.

But there will be additional strains in the bank-country relationship and more disruptions of payments flows. Slow LDC growth and continued uncertainty about the financial viability of debtor countries will hang over the banking system and more importantly, will act as a drag on the world economy.

I believe the time has come to look beyond the next quarterly profit and loss statement of the banks and to consider a new debt bargain that better meets the long term economic interests of the debtors, of the US and of the world economy. The essential element would be a further reduction of the interest payment burden on debtor countries to allow them more room for growth and for internal structural adjustment.

The banking system is in a strong position to make some interest concessions this year. In addition to the build-up of capital and loan loss reserves over the last year the big banks with a few exceptions, have enjoyed strong earnings the last five quarters. Bank net interest margins are at an historically wide level according to Salomon Brothers and non-interest earnings have also been strong the last eighteen months. Stock prices for the group of 35 large money center and regional banks Salomon follows closely rose sharply in 1984 although the money center banks were still trading at below book value. The stocks of the group of 35 banks rose 16% in the first four months of 1985. Many of the large European banks also enjoyed record profits in 1984.

The degree of debt relief would be a function of international interest rates and other external economic factors that affect countries' ability to pay. Such relief could take several forms. Replacing the old floating rates with a new, low fixed rate would be most desirable from the borrowers' standpoint. Capping current interest payments and deferring the rest, adding it to principal would be more palatable for the banks. The deferred interest would then become part of the perpetual rescheduling process but banks could maintain the fiction that it would eventually be paid. German banks have expressed an interest in this approach but US banks have been vigorously opposed. They would prefer to continue to lend more money if necessary to enable debtors to make full payment of interest and maintain the fiction that these are fully performing loans.

European banks are in a better position to make interest concessions. Their overall exposure to troubled debtors is less than that of US or Canadian banks and they have reportedly taken more write-offs and reserves. British banks are said to have written down some loans to Latin America by as much as 50% and some large German banks have written off Poland completely. I should add that European banks generally get more generous tax treatment of reserves and write downs than do U.S. banks. Congress should consider carefully the impact the proposed changes in US tax treament of banks' loan loss reserves. The current law already discourages banks from building up reserves and the proposals in Treasury II I think would be a further disincentive. While I agree that banks should pay more taxes than they do, I also agree with Fred Heldring that "accounting treatment should lead to sound actions, not to attempts to perpetuate a situation which is transparently unstable."

Europeans are clearly nervous about the health of the US banking system. Every announced S&L failure sends tremors through the foreign makrets. An American banker in London admitted that whereas U.S. banks used to pay a little less than others for eurodollar deposits, since the

Continental Illinois collapse, depositors have been just as happy to keep their dollars with non-U.S. banks. U.S. bank funding costs have risen as a result. Virtually every European commercial banker, investment banker and bank regulator I talked to on my recent trip indicated that he thought US regulators had been too soft on the banks with regard to realistic valuation of ldc loans and building up reserves against potential losses. They think US banks are faking their books, and that perception is dangerous to the large banks that depend heavily on the euromarkets for funding.

A more realistic approach to the debt problem would probably benefit US banks in the long run, even if it costs them some earnings.

Under current accounting rules, US banks would have to declare loans on which interest had been reduced as non-performing assets, but not write them off as a loss. Bank earnings would be affected, but not capital, although some write-down of the face value of the asset might be required. An interest reduction would be expensive for the banks, but not as expensive as an outright repudiation by even a few borrowers. For example, the exposure of the nine U.S. money center banks to the twelve largest LDC borrowers--accounting for 62.5% of total US bank exposure to these countries--was $65 billion dollars as of 30 September 1984. Assuming that the borrower is paying Libor, the base eurodollar interest rate, currently at 8% plus a spread of 125 basis points,the gross interest earnings to the banks on these loans (if they were all performing), would be $6 billion. If these payments were reduced by 50% -- a pretty drastic example --the 1984 pre-tax earnings of these banks would also drop by something less than 50% and after-tax earnings by perhaps 30%. Costly, but by no means catastrophic.

The Bank for International Settlements says in its most recent annual report, regarding the finacial situation of the debtor developing countries that "Inverse flows of the order of magnitude witnessed in 1984 are clearly unsustainable, and some form of net capital flows to these countries needs to be restored as soon as possible to offset part of their interest payments." In my opinion, reducing their interest payments is an alternative to increased capital flows.

Representative OBEY. Thank you. What strikes me, if you read the assessment pieces in the New York Times yesterday, if you read the Post pieces yesterday, if you listen to your testimony this morning, what strikes me is that no matter who you talk to or listen to, what people are almost always saying is that the amount that we know that we don't know seems to be larger every year.

People constantly referring to the fact that traditional economic measurements—well, I don't want to say that they don't mean what they used to, but people are having difficulty determining what they really do mean in the context of the existing capital flow situation internationally.

The other thing that strikes me is that if you look at what all of you said today—Mr. Chimerine, you said that these countries will probably muddle through if, if, and if. You gave us three pretty big ones.

Mr. Hormats, in your prepared statement, you also list some pretty big assumptions. Assuming policy improvements continue in high debt countries, assuming growth of 3 percent or above, assuming market access in industrialized countries, no political plunge toward protectionism in an election year.

Then you say, under that scenario, there will be a number of negotiations on new IMF agreements, modifications in several current reschedulings.

And Ms. Lissakers, you also indicate that even if you assume that, you think the string is fairly short.

What that says to me is that unless we are willing to take out permanent charter memberships in the Optimist Club, that Murphy's law is much more likely to take over than any economic theory that we can have strong confidence in.

In hearings before my appropriations subcommittee, Mr. Schneiders indicated that "the worst of the debt crisis is behind us."

Mr. Hormats has made some suggestions about what we can do if we don't deal with some of the other questions that people like Mr. Martin have suggested, and others, in terms of rescheduling.

If we don't—and I recognize that sometimes the most constructive thing you can do is simply just to do nothing for the moment—but what do you think the most constructive thing is that we can do to reduce that degree of risk that we don't hit the optimistic scenario, beyond what Mr. Hormats has suggested by way of the devices we could follow with Exim, World Bank, et cetera, assuming that we are going to hit what the two budget committees say is $50 billion, and most other people say is probably closer to $30 billion in deficit reduction? What else ought we be doing, if you assume that as a given, what ought we be doing to make more likely an unfolding of events which gives us something close to your optimistic scenarios?

Mr. CHIMERINE. Well, Mr. Chairman, from the standpoint of the macroenvironment, I think we've got to approach this problem in a way that would prevent the LDC debt problem from worsening without strangling those countries.

And that's why I think that the type of economic growth scenario we talked about is an absolute minimum, but it may not be the full solution to the problem.

One thing is clear—if the world economic situation deteriorates either because of a resumption of economic stagnation in the United States or elsewhere and/or because of a return to double-digit interest rates, it will make the situation extremely unmanageable and even these more microkinds of solutions won't solve the problem without either some serious feedback effects on those countries. I think you've got to use as a base, as several of us pointed out, that the standards of living in most of those countries are already 10 to 15 percent below where they were 5 years ago. So they can't absorb much more of that.

I think, therefore, the first approach has to be at the macrofront. And that gets at interest rates. It gets at worldwide economic growth. And it gets at the overvalued dollar. They're all interrelated, in our judgment, and the best solution is what we described earlier—get our deficits down as quickly as we can by supplementing some of the spending reductions that are now being discussed in the Senate-House conference with some modest tax increases, but also by going more heavily at some of the entitlement programs to reduce spending in the longer term. In addition, it is important that the thrust that the Fed has wisely adopted in recent months; namely, ignoring M-1 growth and basic monetarism, and focusing more on getting interest rates down, be continued. And third, anything we can do to keep pushing the dollar downward will benefit some of these countries as well because one of the problems for some of the high debt countries is depressed commodity prices. And, to some extent, that reflects the strong dollar. Anything that gets the dollar down that gets interest rates down permanently, as well as speeds up worldwide economic growth, will be very constructive and is almost necessary to prevent the situation from worsening.

It may not be sufficient, but without it, there's no chance of avoiding a very serious problem relating to this high debt situation in the years ahead.

Mr. HORMATS. I tend to agree that the macro is really the key determinant in success or failure. In one sense, I'm optimistic in that the Federal Reserve Board today, in my judgment, takes greater account of international circumstances than ever before in its history.

All of the analysis of open market committee discussions leads me to the conclusion that they are very keenly aware of the impact of their policies on the high debt countries and the dollar. And I suspect one reason—certainly not the only one—but one reason we're seeing a loosening of monetary policy—we saw it in the beginning of the fall of last year and we're still seeing it—is that they understand the consequences of the deep recession in this country, or a shoot-up in interest rates in this country, on the debtor countries. And, in turn, they understand the impact that would have on the financial system and the economy of the United States.

So that, it seems to me, is a very important consideration.

I think that there are several other reasons for optimism. Let me read one portion of a speech that Secretary Baker made on June 21, in Tokyo at the meeting of the Group of Ten:

> The interim meeting in Seoul will be considering a report by the managing director on the possible uses of the resources that will be made available following repayment of loans that have been made by the trust fund.

There's a lot of money there. The trust fund, which was designed to help some of the developing countries following the oil price shocks in the 1970's, lent a lot. It's getting this money back. Some of this is committed to make up the shortfall in IDA. As you well know, Mr. Chairman, that is a problem. But there is still some substantial sums of money that are not committed.

It may well be that those sums can be leveraged or combined with the private sector lending.

I think the basic point is to get prudent increases in new lending to these countries. Karin mentioned the point earlier, and I think it's a valid one, that one part of the deal that was struck in 1982 and 1983 was that if these countries adjusted, they would see additional flows from abroad. And they haven't seen those to the degree they have anticipated.

It seems to me that the banks aren't going to do it all themselves. The Eximbank isn't going to do it itself. But together, if you had the right types of coguarantees or cofinancing, you will be able to use some official money combined with private money to increase flows to these countries.

Let me comment on the interest capitalization idea that was, in my judgment, somewhat imprudently prepared by a member of the Federal Reserve Board.

There are several issues. One is how you make the point, how you make the presentation. Coming right after the Argentines had taken some very tough and needed measures, the timing was highly inopportune, to put it nicely.

Also, it wasn't just the interest capitalization point. He had some scheme where the World Bank would somehow guarantee or take over this money. All of these things were sort of floating around there.

Let me talk about the capitalization idea, in particular.

It is a well accepted feature of borrowing in certain markets like the floating rate note market, that if you are a borrower and you want to insulate yourself from an increase in interest rates, you can put a cap on your interest payments.

Now, in order to do this, you pay a little bit of a premium to the lender. The lender will, say, charge you a little bit more for the money. In return, the lender accepts the fact that if interest rates go up above *x*, the borrower won't pay anything above that level. In other words, there's a cap on the interest payments that the lender will be repaid by the borrower.

And this is all built into the terms of the loan. It is not a new phenomenon in the market. It's done. And the terms of the deal are different in order to make it a little bit more attractive for the lender, but it can be done.

In fact, on new bank lending, it seems to me, there is every reason to believe that this type of feature could be worked out between borrowers and lenders. Obviously, there would be negotiation of the terms, but that technique is not an unknown one and probably a very appropriate one with respect to new lending.

The difficulty comes, in part, because the regulators have not allowed old loans to be revamped to put these new types of caps in. But that type of technique is not in the future one that we should dismiss as being inappropriate or unusual.

I think the way it was done in that statement, and the fact that it was combined with a lot of these other things has blurred the debate.

Now the banks will have to work this out case by case with the debtors. But it strikes me that this type of idea should be pursued.

There are a variety of other ideas that we could go into.

Representative OBEY. Do you want to add anything?

Ms. LISSAKERS. Yes, just to pick up a little bit on Bob's last point. In the longer term, if one looks at the changes that are taking place in the way that the capital markets operate and the sort of blurring between the securities markets and the capital markets and the credit markets, there are probably opportunities for sovereign borrowers which could give them access to a broader base of lender, a broader source of funds, and a more stable source of funds.

If you look at what Sweden has been able to do in the last couple of years, for example, it has completely restructured its external debt and reduced the bank component and gotten more fixed rate and a more variable and flexible debt structure, which gives them the opportunities to go into the market and get out of the market more or less when they want to and to get a bigger variety of currency in their debt and all sorts of gimmicks.

And I suppose that one can look forward to the time when less prime-sovereign borrowers might have access to some of the same instruments. The problem is getting from here to there and getting from here to there without any major crises.

And when one looks at the constraint on the countries, it comes down to the interest payments to the bank. And obviously, the major component of that is the base interest rate which is the function of the U.S. Government policy and of U.S. deficit and what Congress does on the budget.

I mean, I hope you're not saying that we simply have to resign ourselves to the fact that there's only going to be a $30 million cut in the U.S. budget deficit this year. One hopes not. Macroeconomic conditions, the U.S. growth rate, and the interest rate are really the most crucial point. One can tinker with a bank-sovereign country arrangement and certainly do something to ameliorate the situation, but the broader macroeconomic conditions are obviously the governing factors in what's going to happen in this debt situation.

Representative OBEY. Let me just ask one quick question and I would appreciate short responses so that we can get to Congressman Hamilton.

But following up on your responses, let's move beyond what—you all emphasized macroaction that we need to be taking—moving beyond that, getting into some of the other things that we've been touching on, Felix Rohatyn last week said twice—well, let me put it a little differently.

We had testimony in our other committee last week to the effect that we cannot put pressure on some of these Latin American countries on the drug traffic because it will put such tremendous pressure on the governments that they may collapse. And so, therefore, we have very limited pressure that we can put on them.

And yet, we are putting excruciating pressure on them in order to assure that they adhere to their payment schedule to the banks.

Felix Rohatyn indicated that he felt that our concentration, when you mentioned, Mr. Hormats, our concentration on Nicaragua and El Salvadore, and really dismissing for the moment some of the tougher problems in Argentina, Brazil, et cetera, and the pressures that we're putting on these countries to repay is really going to cause us more long-term damage and put at risk democracy in that part of the world than is sane for any country in our position.

I recognize the timing problem that you have associated with Mr. Martin's suggestion, but Rohatyn is also suggesting that, just flat out, we ought to be, if not doing it now, we certainly ought to be laying plans for at some time in the reasonably near future reshaping those debt obligations, or we will face much worse results than we would like to think.

Does anybody strongly disagree with that?

Mr. HORMATS. I haven't seen this particular version of the Rohatyn plan, but I've seen earlier ones. They smack of the grand design and they miss the point that there are a number of differences among debtor countries.

The great success Rohatyn had in New York City has led him to believe you can do for the world what you can do for New York City. It's a lot more complicated than that.

I think you have to do it case by case. I don't think the grand designs are going to work. I don't think somehow having the World Bank pay this money back and issue bonds that some mythical buyer is going to buy, which tends to be one type of scheme that you hear, is going to work because that reduces the creditworthiness of the bank.

A lot of these grand designs really are not going to get political support and really don't make too much economic sense.

Representative OBEY. Well, forgetting that, I guess my question is should we admit, as I think some of the testimony that some of you have given, at least marginally suggests, should we admit that these are not loans that are likely to produce sufficient repayment over the next few years and should we be thinking now about the banks themselves making significant adjustments in those repayment schedules in order to encourage the ability of those countries to grow enough to do something other than pay their debts?

Mr. HORMATS. I think it differs from country to country. Some of the loans are payable; some aren't. And I think when one makes the judgment as to whether or not they're payable, it depends on a whole broad range of other circumstances.

My instinct is that in a number of the bigger countries, perhaps not all, but in most, if one provides the sort of resources that they need to undertake the economic restructuring and improvement that they are, in many cases, planning, then with a considerable amount of pain and adjustment, the loans are over a period of time payable.

My guess is that in a few of the medium-size countries—I've mentioned a couple of them—they are, for the foreseeable future, not payable. I don't think that the terms, country by country, can be worked out in advance. We need to do this on a case-by-case basis. And if there are situations like Bolivia, the banks and the Bolivians will somehow find a way of working out an accommodation—which probably won't be particularly satisfactory to either.

The grand designs, I think, lack an awful lot of credibility and simply don't deal with the differentiation point that I mentioned earlier.

I do think, however, that we have to begin to think about, as you say, the situation. If the thing should deteriorate, what do we do? And there, it really depends on the type of deterioration. If the deterioration is in the form of a big increase in interest rates, then it seems to me you can find some means, some type of interest rate smoothing out process.

That, as I say, is not an unusual idea in international transactions.

More difficult is what happens if the disruption occurs because of protectionism in the industrialized countries, or a big decline in industrialized country growth. Then we can cap interest rates and do all we want. That really won't matter.

It seems to me that's the bigger risk. That's why I think that the interest rate capitalization idea, while there may be ways of doing it, may not really be the central risk of the moment, which is a decline in growth. And there's no other answer except to find some way of helping to cushion the resource decline which would occur as a result of that weakness in industrialized country growth and the ultimate inability of these countries to increase their exports.

It's not a capping problem; it's a resource problem and that's the reason that I concentrated earlier on ways of trying to foster flows of new resources.

Unless we're able to do that, and it seems to me that it will not be just the banks, it will not be just the Government, but it will be the Government, the banks, and these new sources of capital—pension funds and other types of financial market institutions—unless we can find some creative means of doing that, leveraging certain resources in order to do that, we are going to find the system vulnerable.

Representative Obey. Congressman Hamilton.

Representative Hamilton. Thank you, Mr. Chairman. This has been a good panel. I've appreciated the opportunity to attend.

It seems to me that the policy difference between you, Ms.—how do you pronounce that last name?

Ms. Lissakers. Liss-akurs.

Representative Hamilton. Lissakers—I'm sorry, I didn't know—and the other panelists, is that you believe we should cap and forgive right now, and that they talk in terms of additional resources, muddling through, and the like, and apparently, oppose the idea of beginning to discuss a cap or forgiveness at the present time.

Then I ask myself, why that difference with you, or among you? And it seems to me that the key to it lies in your prepared statement, where you say that this arrangement that we now have, or the idea of muddling through, is not really acceptable for U.S. public policy, although it may be acceptable for the U.S. banks.

And the reason that it's not acceptable for U.S. public policy is it doesn't provide any real economic growth in the areas of Latin America.

I also had the impression in your prepared statement that you, in a very diplomatic way, you're really very critical of the banks here. And so I think we ought to really let the bankers respond to your fundamental criticisms here.

Are the banks really focusing on the problem in terms of getting their money paid back? Is that their major concern here? Have they, in fact, on the existing bargain that she talks about, really defaulted, in fact, because they're not going to be putting additional resources in? And is, then, some kind of a new bargain necessary?

I'd like to hear the response.

Mr. Chimerine. Well, Congressman, I'm not a banker, but I'll take a stab at it, anyway, and then perhaps my colleague can add to what I have said.

Representative Hamilton. Those of us from Indiana think that any of you from New York tend to be bankers. [Laughter.]

Mr. Chimerine. I'm from Philadelphia. [Laughter.]

I think that the issue gets back to the amount of hardship in the LDC countries and what the banks and other lending agencies have done to mitigate that problem. I don't think anybody would suggest that we should completely forgive all these loans. The question is a matter of balance. And by any standards, I think, the banks have bent over backward in recent years to stretchout many of these loans, to defer payment of principal, to reschedule payments, and have made significant efforts in order to mitigate the problem, at least in the short term, on some of these high debt countries.

Now, this is a matter of judgment. We can always argue that they should be doing more or less. I don't think that anyone can disagree with the view that they've moved heavily in that direction. Interest rates are not really the problem at this point. Interest rates are coming down and even if we cap interest on some of these loans, the savings will be a lot less than it would have been when interest rates were 4 or 5 percentage points higher.

The big problem is slow worldwide economic growth. If those conditions continue, there's no way the banks can continue to make new credits available to the LDC's to cover the shortfall in their needs. And under those conditions, they're either going to have to permit more reschedulings or some other source of financing will have to become available. But at this point, I don't see how anyone can argue against the fact that the banking system in the United States has moved extensively in the direction of rescheduling, principal deferrment, and of other ways of reducing the short-term impact of the debt problem on some of the LDC's.

Representative Hamilton. But would you agree that normal lending has not resumed?

Mr. Chimerine. I think there's been some.

Representative Hamilton. Would you agree that that was part of the implicit or explicit bargain?

Mr. **Chimerine.** I think part of the bargain is that there would be some. I can't really argue whether or not they come forward with as much as they should have.

But there has been some increased credits supplied to some of these countries during the last several years during their adjustment period.

Representative **Hamilton.** But normal lending is not taking place now. Is that a fair statement?

Mr. **Chimerine.** It has been very limited, yes.

Representative **Hamilton.** Bob.

Mr. **Hormats.** Well, since Congress, in its wisdom, years ago passed the Glass-Steagall Act, fortunately, investment bankers have saved themselves a lot of money and are not involved in direct lending to these countries. So I can't speak for the banking community.

I'd make a couple of points.

I think that there has not been the sort of resumption in voluntary lending that I, and I think many of us, had hoped for over a period of time, largely for the reasons that Karin has mentioned earlier. There is a reluctance to increase lending portfolios to troubled countries and there are a lot of very attractive loan possibilities in a growing and deregulated banking environment in this country. And when you combine the two, there has been a negligible amount of voluntary lending—I don't know what the amounts are, but it's not very much. Karin probably knows it better than I do.

I don't have any intellectual argument or political or economic argument with capping. As I say, it is an established technique in the markets and as long as the cap is negotiated between borrower and lender, it's something that's done relatively frequently.

And, in my judgment, the new lending to these countries, both voluntary and involuntary, should have, if it can be negotiated between the borrower and the lender, some type of cap. That's a very prudent technique and is something that is done in mortgages in the United States. It is not unusual and it could be done.

It's harder to redo old loans, to put a cap on them. But even there, maybe some way of smoothing out repayments that can be worked out.

I simply don't know. That's something that would require a lot more detailed negotiations and involve the regulators.

My basic point is, and I think we both indicated from all of our projections about the future, that interest rates may rise in the near-term a little bit. That's certainly a possibility. And there's always a chance that they could rise a lot. And we could probably, through some type of capping, deal with that.

The bigger risk at the moment is that we will see a weakness in demand. And a weakness in demand will push rates down further, most likely.

So that if one has a certain amount of energy and a certain amount of political will, then the key point is to use what energy and efforts we can to deal with what is the most proximate problem—the most likely problem—and that is a weakening of growth which will weaken developing country exports and probably in the process push down interest rates.

The question is how do we deal with the prospects of a weakening of growth and what do we do to shield the developing countries from that tragic prospect? And that really involves not so much capping of interest rates, although, as I say, I have no intellectual argument with that. The most immediate problem is to get more resources to them, particularly if the world economy deteriorates because——

Representative **Hamilton**. What do you mean when you keep saying "no intellectual argument"——

Representative **Obey**. Could I interrupt just a second, please, Lee? I'm told that Mr. Chimerine has to leave.

Representative **Hamilton**. I see.

Representative **Obey**. I see him nodding in agreement with Mr. Hormats. [Laughter.]

That will have to be his last comment this morning. Thank you.

Mr. **Hormats**. When I say "no intellectual argument," I mean I have no problem with either the technique of capping interest rates or the validity of capping interest rates. It seems to me that it is a very valid and, in fact, widely used technique. Billions and billions of dollars of floating rate note issues today have capped interest rates on them.

So it's not something that I object to on the grounds that it's wrong or inappropriate or anything else. I'm simply saying that the near-term problem is more likely to be a growth problem than a run-up of interest rates.

That's my basic point.

Representative **Hamilton**. What happens if we have a $200 billion deficit for the rest of this decade?

Mr. **Hormats**. What happens?

Representative **Hamilton**. Yes, what happens? Suppose we don't make much progress on getting this deficit down, we don't make as much as we'd all like to. Suppose you have a $200 billion deficit in the U.S. budget. What happens, then?

Mr. **Hormats**. It's hard to predict. You're more than likely to have over a period of time a weakening of the economy because of dissavings. It's using money for nonproductive uses, nonproductive in an economic sense. They may be productive in a political or a social or a military sense.

A lot of the private sector borrowing is for investment, although obviously some is for consumption. When the Government borrows, it's mainly for current expenditures, which don't improve the productivity of the United States, don't improve the capital base.

Representative **Hamilton**. What happens with regard to this debt payment problem?

Mr. **Hormats**. Well, it depends on a number of other things. It depends in part on the Fed policy. It will put a lot of pressure on the Federal Reserve Board to monetize those big deficits. If it resists, that will mean, in the short term, probably an increase in interest rates. In the medium term, it will probably mean a substantial weakening of growth.

Representative **Hamilton**. And with regard to the debt payment, it makes it impossible——

Mr. **Hormats**. It's a double negative for the debtor countries, because it will mean, in the near term, probably a higher dollar, somewhat higher dollar, which hurts them because much of their debt is in dollars. In the near term, it will probably mean somewhat of an increase in interest rates. That depends in part on a number of other elements of Fed policy.

In the long run, it's very bad. And bad for us, bad for the United States.

Mr. Hamilton. You mentioned in your comments that some of the debtor countries have handled the situation pretty well.

Mr. Hormats. Yes.

Representative Hamilton. And that we could learn from them. What is it that you have to learn from them?

Mr. Hormats. I think it's useful to look at the differences in policies. Columbia is one of the countries in Latin America which has maintained creditworthiness throughout this whole very difficult period. But let's take an interesting case of Korea.

Korea in the early 1980's had a very serious debt problem. It confronted that problem earlier than many of the countries of Latin America.

Now what did it do? It had large Government subsidies. It cut those subsidies—not entirely, but to a degree. It had an overvalued exchange rate. It reduced the value of the exchange rate. It did a number of things to liberalize the internal economy.

And I think if you were to make the distinction between the types of policies which made the debt problem manageable and the types of policies which have contributed to the seriousness of it for certain countries, you could identify a few key variables. One—exchange rates. Virtually every country that's encountered a major debt problem has had an overvalued exchange rate. And this has meant a whole lot of other subproblems.

Second, very large-scale government borrowing, in part for state-owned enterprises. A lot of subsidies, a lot of government borrowing in order to pay those subsidies.

Three, distorted price systems—they held down the price, for instance, of oil or food, and therefore, didn't provide the right production and conservation incentives.

The fourth is that a lot of the Latin countries pursued internally oriented policies. The East Asians were more export-oriented and therefore, when they encountered these problems, they were able to improve their competitiveness and relatively quickly boost their exports, not eliminate, but to help overcome debt difficulties.

So these countries can learn from one another. We're perhaps not the best teacher, in fact—certainly not when it comes to reducing budget deficits.

Representative Hamilton. Are you impressed with what Argentina is doing now?

Mr. Hormats. I am impressed with the fact that President Alfonsin has been able, in an awfully difficult environment, to make these bold policy changes. How they'll work out remains to be seen. But I think that he's taken a very bold set of steps.

Representative Hamilton. The economics, quite apart from——

Mr. Hormats. Yes.

Representative Hamilton [continuing]. Forget the politics.

Mr. Hormats. The basic——

Representative Hamilton. The economic steps are sound?

Mr. **Hormats**. The basic economic steps are sound. They'll be very painful to implement, but I think that he knew, and most people in Argentina knew, that they needed to confront these problems in their own interest, not just in the interest of dealing with the debt problem. What is it, 1,000-percent inflation, something like that? They couldn't live with that.

Yes, I give him a lot of credit on economic and political grounds for this.

Representative **Hamilton**. Thank you, Mr. Chairman.

Representative **Obey**. Thank you.

Ms. **Lissakers**. Could I just——

Representative **Obey**. Oh, sure.

Ms. **Lissakers** [continuing]. Make one brief comment? I don't want to leave any misimpression about what I'm saying about the banks' side of the bargain.

When I say that they're not holding up their side of the bargain, I also say that they are right in not increasing their lending at this point, in terms of their own position and the soundness of their own balance sheet.

So I'm not saying that this is somehow wicked or evil on their part. I'm saying that that is simply the situation and it's likely to be the situation for some time and that, therefore, the underlying bargain in the current debt restructure approach is not tenable, even over the medium term.

Representative **Hamilton**. But you would move right away to cap, forgive.

Ms. **Lissakers**. I certainly think it's something that we should have that should be in the back pocket. I mean, it depends. As Bob says, if interest rates continue to drop significantly, then the interest, the immediate interest payment problem becomes less significant for these countries than some other aspect of the problem. And therefore, that's not necessarily the right response.

Representative **Hamilton**. Well, there's a difference between doing it right now and having it in your back pocket and you can do it later.

Ms. **Lissakers**. Yes, there is. There is. I mean, I'm saying maybe sit through this year and see what happens with interest rates.

Representative **Hamilton**. I see. Thank you, Mr. Chairman.

Representative **Obey**. Thank you. As Congressman Hamilton is pointing out, there's an awfully tough line to walk between the policy that allows the banks to strengthen themselves to be in a better position to hedge against future problems and allowing the developing countries to strengthen themselves in the hedge against all kinds of political and economic developments that might not be very pretty for them or us.

I don't know if Mr. Greenspan is going to be regarded as the Cassandra given his estimates of what the prospect is likely to be through 1990, but let's say his scenario was right, that we, between now and 1990, see economic growth significantly lower than that 3 percent magic line that people seem to point to.

If that's the case, then, Mr. Hormats, I guess—how long do you think we should wait in assessing whether something more needs to be done in order to prevent problems in that part of the world?

I mean, one thing that bothers me is that, I think while everybody is making a lot of the fact that we have a lot of budding democracies in that part of the world these days, that in some cases, we have that because the military couldn't figure out how to handle the economic problems.

Mr. HORMATS. Exactly.

Representative OBEY. And discretion was the better part of valor. And so let the politicians take the heat.

You indicated that we maybe ought to wait it out this year. What's your suggestion for timetable? What if this flash that we got last week is a flash in the pan rather than a signal that we have resumed significant growth?

Mr. HORMATS. Mr. Chairman, I wouldn't wait too long to do some of the things that I mentioned in the testimony. That is to say, I think there are a lot of arguments to be made for, in the near term, moving to find ways of increasing the financing of exports to these countries, of utilizing more cofinancing, of taking advantage of the reflows from the IMF trust fund.

We talked about capping, but there are, I think we both agree, an awful lot of other things that can be done right away. And it seems to me that there is no time to be lost in moving on some of the methods of increasing flows of resources to these countries, because the more you do that, the less political pressure on them there will be now and in the future. It strikes me that that is a very prudent course of action to take right away.

Representative OBEY. Let me ask any of you one last—at least I think it will be the last. I looked at a little paper over the weekend, "The Debt Problem—1984 and Beyond," by Mr. Rittiger Dornbusch, MIT. Part of what is suggested in that paper is this—let me just read a piece of it:

> A single premise of the adjustment process is the proposition that debts must stay intact and profitable to maintain the system, yet equity and good foreign policy are simply—Long-run sense would indicate that some writeoffs are in most people's interest. The issue should be addressed simply by asking what the prospects are, thinking in terms of a decade for Latin America. The standard view is that debtor countries will over some years work down their debts relative to exports by a combination of trade surpluses and export growth, and that one day some day banks will spontaneously decide that enough is enough, turn around, and resume voluntary lending. There's no assurance that this will happen; certainly no indication as to what is enough. Indeed, domestic regulators wince at the very thought that banks should think of renewed foreign lending. The priority is clearly that LDC debts should become a negligible item in both debtor countries and commercial banks' balance sheets, until them austerity. But the prospect that commercial banks will seek to reduce their LDC exposure means that most of the interest will have to be earned rather than borrowed. The prospect combines with the unquestioned scarcity of official lending and the lack of significant direct investment. It adds up to the proposition that for the next decade, Latin America will be a net exporter of resources.

Do you agree that that's likely and what other comments would you have on that statement? And do you think that such a prospect would be sustainable?

Ms. LISSAKERS. I think if we continue the current arrangement, that is the prospect, but I don't think that's sustainable because I don't think that's tolerable for those countries, either politically or economically.

I mean, you will have spasms in the financial flows where countries may make an effort and then they will fail or there will be strikes or there will be problems domestically.

Even if countries somehow manage to do this for 2 or 3 or 4 years, my point is simply that that should not be an acceptable outcome. That is not a desirable outcome from a broad U.S. public policy interest, either political or economic, and that we should aim higher. We should aim for something better than that.

I mean, the capping of interest rates, interest payments for the banks is really just one feature. I focused on it because I was talking about the banks-creditor country relationships. And that seems to me to be a more likely, a more acceptable measure to ease the situation than more lending by the banks.

But there are certainly other things that can be done, that should be done on the official side and should be done as soon as possible.

Congress, for example, I think, is now going through the process of authorizing funding the development banks. And I think it would be very useful if Congress would take a look at this administration's policy with regard to counterpart funds, for example. I mean, it's not a huge amount, but it's a significant amount. And it's yet one more constraint on what those countries can do internally to stimulate their own economies and do something to ease the conditions under which people live in those countries.

A number of other measures can be taken—export finance support and leveraging some of the World Bank and other funds. So I think that there are certainly steps.

The other side where I think more action is needed is on strengthening the banks. The U.S. banks have not done enough yet to write down foreign loans—it's ludicrous to be carrying the Argentine debts at 100 percent of face value. It may be that some day Argentina will be able to repay many or most of these loans. But you certainly shouldn't be operating, showing your books on that assumption now because it's not a realistic assumption.

And the other aspect is, I think the banks—our current tax setup is such now that there is an actual disincentive for U.S. banks to build up loan loss reserves. And I think that something could be done in that regard without significantly affecting the U.S. tax revenue and give the U.S. banks the kind of allowance that the German banks have, for example, to take loan loss, build loan loss reserves out of pretax income rather than posttax income.

And the proposal that's in Treasury II with regard to loan loss reserves I think is a bad one because it's going to be a further disincentive to building up loan loss reserves. And banks should be strengthening themselves more than they have so far to face the prospect that you're going to have a deterioration in the debt payment situation.

Representative Obey. Do either of you want to say anything?

Mr. Roldan. When we are considering the next 10 years, Mr. Chairman, I think we also need to look at the other side of the coin; namely, the type of adjustments that the developing countries themselves are pursuing in their domestic economies in order to improve their economic health.

If we feel that banks might not be living up to their bargain by not lending additional funds to these countries, I think there's one reason, and that is that we had a third party in the bargain, and that was the IMF. The IMF assured the banks that countries were going to go through adjustments that were not only going to solve the cash-flow problem on the balance of payments in the high debt countries, but that they were also going to solve the domestic disequilibrium problems; namely, the high fiscal deficits and high inflation rates.

If we look back, there has been, indeed, a very substantial adjustment on the external side of those economies, but not the same progress on the domestic side. Despite the fact that the adjustment costs have been very large in terms of foregone output investment reductions and income per capita reductions, we still have not solved that fundamental domestic equilibrium problem: inflation rates are still growing very rapidly in these countries.

I think, there, we have to look at the other partner in the bargain, the IMF, and the policies that it has been prescribing in these countries.

From some perspective, it seems that we have lost a golden opportunity to force or institute in those countries the economic policy adjustments that would allow a long-term improvement in their internal economic equilibrium.

Still we have the inflation and the inflation outlook hasn't improved. The risk is that high debt countries will go back to the old habits, and fiscal deficits, and that banks will be unable to lend freely under market conditions for a long time.

Mr. HORMATS. Just one final thought. I think that while we talked a little about and debated the point of interest rate cap, I think neither of us would want you, Mr. Chairman, or Lee Hamilton, to come away thinking that because we differed a little bit, and probably not very much, on when to use that or about that technique, that we both don't share the sense of urgency.

I think that's the key message of the whole thing, that there are big risks out there for the United States and for these countries, and that the cap is simply a technique.

The broader point, and, I think, the more fundamental one from the point of view of the interest of this country, is that we have big political stakes in these countries and that there are a number of things that we can do right away that are consistent with promoting the adjustment that these countries clearly need to promote, but enables them to do this in a way which is not so socially and politically painful that it creates internal pressures in those countries to deviate from their adjustment.

And it seems to me that there are a number of things that can be done, and I would urge this committee, in its dialog with the executive branch, and in its own deliberations on such things as the multilateral banks, to take this with a sense of urgency, as I know you do, Mr. Chairman, because it is very important to our financial and our political interests.

Representative OBEY. I just have to say on the last point, I certainly agree with you that it's essential to buttress support for the international banks. The problem is that everyone seems to think that that's important enough to do, but that it's not important enough to pay for.

Mr. Hormats. Yes.

Representative Obey. Nobody on our subcommittee is a Wizard of Oz or any other kind and we can't—I just don't think that you can find the votes to do anything—I don't think you can find the votes to even meet the administration's request for the banks this year, so long as that's all borrowed, because people know in their gut that that doesn't make sense. They just aren't willing to talk to the country about what you have to do about it.

That's the dilemma we have. We see the problem, but there is not support in the administration or the votes in the Congress to do anything about it.

Ms. Lissakers. Of course, something like counterpart funds doesn't require additional resources, but just the internal rule change that would allow release of funds that are already in the banks more quickly.

Representative Obey. And the problem is that now, however, the focus is almost exclusively, as you've indicated, on Central America.

Mr. Hormats. Yes.

Representative Obey. I recognize that the AID budget is not something which absolutely reflects the attention we're giving to the countries, but if you take a look at the $440 million to El Salvador, population of 5 million or so, and if you take a look at the 2 percent of that amount that we are looking at for Argentina, admittedly, they are far different problems, but I think at least for the moment it does give you some rough indication of the attention being focused on both countries. Yes, Mr. Roldan.

Mr. Roldan. I would also submit some numbers of magnitude in here, Mr. Chairman, because the initiative that one would like to take on the interest rate side has a limited impact in terms of the amount of money that we're talking about, for the high debt countries.

A 1 percentage point decline in interest rates that would come through a cap, only amounts to something like $4 billion, $5 billion in savings. By contrast, if you have the U.S. economy, for example, altering its growth rate by 1 percentage point, the impact is far larger. Over $15 billion in extra revenues would come or go to those countries.

Representative Obey. I agree. But if we have less growth than people are expecting, my problem is that I don't think next year we get by pressures for real protectionism, which really puts a crunch on the situation.

Thank you all very much.

Mr. Hormats. Thank you, Mr. Chairman.

[Whereupon, at 11:55 a.m., the committee adjourned, subject to the call of the Chair.]

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